Next

Budget Footnotes

A NEWSLETTER OF THE OHIO LEGISLATIVE BUDGET OFFICE FEBRUARY, 1999

FISCAL OVERVIEW

— *Frederick Church*

Unfortunately, the state's fiscal picture as of the end of January is distorted by a variety of timing issues. The picture should be much clearer by the end of February. A list of the adjustments that need to be made to the raw January figures follows:

(i) Corporation franchise tax collections were $25.0 million instead of $155.7 million, a $130.7 million shortfall. This is a payment processing and posting issue, not a substantive one. The first payment against the franchise tax is due January 31st, and so revenue fluctuates unpredictably between January and February from one year to the next. While the combined January-February first payment revenue may well end up being below the estimate, the shortfall will be a few million dollars, not $130 million.

(ii) OBM did not make $652.8 million in transfers to the GRF that were anticipated in January. First, the GRF share of the FY 1998 surplus that will be used to pay for the tax year 1998 income tax reduction was not transferred. The share of the year-end surplus going to the tax cut was $701.4 million. The GRF share of this amount is 89.5 percent, or $627.8 million. This money was transferred to the Income Tax Reduction Fund (ITRF) in July. OBM had estimated that it would be transferred back to the GRF in January, to help offset the lost income tax revenue from the 9.34 percent cut in income tax rates, which affects tax filings from January through April (or August, given filing extensions). We presume that the transfer from the ITRF to the GRF will be made in February.

(iii) Medicaid disbursements in January were lower than they should have been due to a delay in payment for certain service categories. The underspending in Medicaid, both for the month of January and for the year as a whole, is no illusion. However, the variance in January was particularly large (negative $55.6 million), when it probably should have been more like $33.0 million. This late payment of claims affected reported disbursements in hospital care, prescription drugs, and physician services.

The distortions to the state's bottom line described in sections (i) and (ii) act to depress year-to-date GRF revenue by about $780 million. The Medicaid distortion described in (iii) reduces expenditure by $22.6 million. The net effect on the bottom line is about $758 million: i.e. the state looks $758 million worse off than it actually is. So, the unobligated fund balance in Table 1 should be about -$120 million, much better than the -$878 million actually shown.[1]

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STATUS OF THE GRF

ISSUES OF INTEREST

VIRTUALLY LBO

Budget Footnotes is issued monthly by the Legislative Budget Office (LBO), a non-partisan fiscal research agency serving the Ohio General Assembly.

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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Because of the distortions to the revenue picture, our standard graph of year-to-date revenues and spending shows both the actual data and the data adjusted for the three problems discussed above.

The personal income tax is still the growth engine for state revenues. Collections are $44.2 million over estimate, and have increased by 7.8 percent from last year. The other major taxes have faltered somewhat. Setting aside the timing-induced shortfall in the corporation franchise tax, there are shortfalls — with respect to the revised estimates — in the other taxes as well. The non-auto sales and use tax is $16.3 million below estimate. January revenues from this tax were a disappointing $13.2 million below estimate. The holiday selling season did not generate enough activity to make the estimate. Preliminary indications are that February collections will not make the estimate either. If so, then the hypothesis that holiday sales were merely “pushed back” from December into January post-Christmas sales does not hold up. This could be the sign of an eventual year-end shortfall in the sales tax for FY 1999, something that seemed unlikely at the end of December.

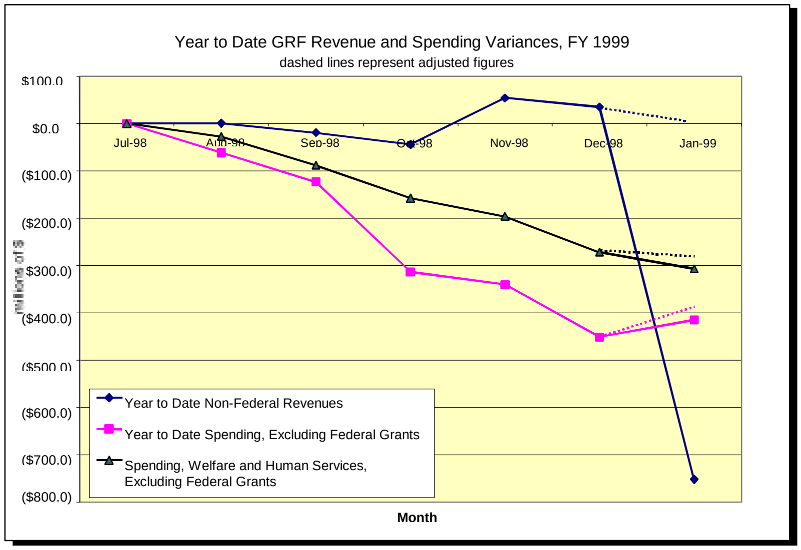
The auto sales tax had a bad January, shaving the year-to-date overage down to an almost imperceptible $1.0 million. However, poor January sales were probably the result of bad weather in the first half of the month. Auto sales are expected to bounce back in February. The public utility excise tax is $27.4 million below estimate. The next estimated payment is due March 1st. Until March, we won’t know any more about how much bigger the shortfall might get by year’s end. Currently, it looks like the tax could end up about $35 million short.

In general, the shortfall in the non-auto sales tax makes us much more cautious about state revenues. It now appears that by year’s end, the franchise tax, sales tax, and public utility tax will all be below the revised estimates. The question then becomes whether the income tax overage will be large enough to offset those shortfalls.

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

	Month of January	Fiscal Year 1999 to Date	Last Year	Difference
Beginning Cash Balance	($497.7)	$1,649.0		
Revenue + Transfers	$1,813.7	$10,120.1		
Available Resources	$1,316.0	$11,769.1		
Disbursements + Transfers	$1,410.3	$11,863.5		
Ending Cash Balances	**($94.2)**	**($94.2)**	**($107.7)**	**$13.5**
Encumbrances and Accts. Payable		$784.4	$505.3	$279.1
Unobligated Balance		**($878.6)**	**($613.0)**	**($265.5)**
BSF Balance		$906.9	$862.7	$44.2
Combined GRF and BSF Balance		**$28.3**	**$249.7**	**($221.3)**

The state is getting a boost in non-tax revenues. Discounting the shortfall in transfers, non-tax revenue is $21.8 million over estimate, led by a $27.8 million overage in investment earnings. However, federal grants plummeted in January, falling $39.2 million below estimate. Year-to-date federal revenues are $61.8 million short of the forecast, which is actually moving closer to what one might expect given the magnitude of the underspending in human services programs.



On the spending side, welfare and human services programs continue to fall sharply below estimate. Medicaid and TANF were $55.6 million and $21.7 million below estimate, respectively, in January. We mentioned above that the Medicaid underspending should have been only about $33.0 million. This would reduce the year to date negative variance from $194.6 million to $172.0 million. However, even making this adjustment, $172.0 million is a big variance (5.4 percent). Medicaid spending has only inched up over last year's levels. The year-to-date increase is 0.2 percent unadjusted, 0.9 percent adjusted.

TANF spending is now $99.9 million below estimate, and has dropped by 8.9 percent from last year. Spending for the year is 16.7 percent below estimate, which dovetails nicely with the fact that the number of recipients has fallen by 16.8 percent (just over 57,000 people) since the beginning of the fiscal year. So far, $33.7 million of TANF underspending is from the state's Maintenance of Effort (MOE) share, while $59.5 million is from the federal TANF grant. The remainder is from unspent prior-year encumbrances.

Other Welfare is also $62.7 million below estimate. Right now, analysts seem to be attributing that variance to timing matters. We will cautiously note that we've said that in prior years and ended up with underspending.

Primary and secondary education and justice and corrections both had big overages in January, but all these did was reduce what had been very large negative year-to-date spending variances. The catching up in education spending may be relatively short-lived. One of the programs that has been below estimate is Disadvantaged Pupil Impact Aid (DPIA). DPIA was restructured by HB 650, and funding was substantially increased (by about $105 million). However, in the first part of FY 1999, DPIA spending was being based on FY 1998 funding levels. In January, the department of education made a catch-up payment, but inadvertently counted kindergarten ADM (students, for the plain-English crowd) twice. So, some of the January overage will be reversed in February.

There are a number or education programs and line items that are below estimate for the year. One that stands out is pupil transportation, which accounts for $33.7 million of the $39.4 million in net underspending. There is a $27 million set-aside for handicapped transportation that has not yet been disbursed, and it is unclear when it will be disbursed. There is more detail on these K-12 education variances in the detailed spending review, in a later section.

We reiterate that in both the text and the tables, LBO's comparison of actual and estimated revenues and spending, both monthly and year-to-date, are based on OBM's revised forecasts from July, not the original projections. Thus, when we say that revenues are above the estimate and that spending is below, it is with respect to the revised forecasts. The variances would be even larger if the original estimates were being used. ❑

TRACKING THE ECONOMY

— Frederick Church

"Life is short, science is long; opportunity is elusive, experiment is dangerous, judgement is difficult."
— Hippocrates

Despite the good economic news that we have seen lately, particularly the 5.6 percent 4th quarter growth in real GDP, the major economic forecasting firms are standing fast by their recession probabilities, although they have pushed back the timing somewhat. The WEFA Group now puts the probability of a moderate recession starting in early CY 2000, rather than late 1999, at 30 percent. The elements of WEFA's recession scenario are:

- The world economy slows in 1999 and then dips into an outright recession by the end of the year. Reduced exports and manufacturing output leads to lower profits and a shock to equity markets. The US stock market experiences a decline similar in magnitude to the 1987 crash.
- Lower and more uncertain profit streams and more excess capacity lead to declining investment in capital goods and structures Plummeting asset prices induce banks to restrict lending. The credit crunch that ensues also reduces real investment spending.
- The general decay in the economic environment sours consumer sentiment and spending. A recession begins in the first quarter of 2000, resulting in a -1.4 percent growth rate for CY 2000.

Good economic news has caused DRI to increase its forecasted growth rate for real GDP in CY 1999, from 2.2 percent to 2.7 percent. Like WEFA, DRI still puts a 30 percent probability on a near-term recession. Like WEFA, DRI has pushed back the starting point for this possible recession to early CY 2000. The elements of DRI's recession scenario are:

- A major stock market correction is triggered by a deteriorating global economy. Consumers are spending out of wealth (evidenced by the low savings rate) and are thus sensitive to a drop in wealth. Consumer confidence and consumer spending fall.
- A recession begins early in CY 2000. However, the Federal Reserve moves quickly to cut interest rates, which they can do because inflation is still low. So, any downturn is likely to be shallow, with a strong rebound by the end of CY 2000.

DRI's mention of Federal Reserve rate-cutting brings up an interesting point. Neither of the forecasting firms has mentioned the impact of the presidential election in CY 2000. Of course, the Federal Reserve is not a political body and avoids bowing to political pressure. However, the Fed also does not want to be accused of influencing an election by following a policy that allows a recession to occur around election time. There will be external and internal pressure on the Fed to avoid a situation in which the economy is worsening in the second half of CY 2000. From that perspective, an early recession followed by a late rebound looks better to public opinion.

The remainder of our brief economic overview will focus on two areas, consumer spending and manufacturing. The first subject is extremely important for the economy as a whole, while the second is of particular significance to Ohio.

Consumer Spending

Some of the growth in consumption spending has been fueled by strong income growth and by employment gains, and has thus been driven by economic fundamentals. However, some of the growth in spending has resulted from the wealth effect of higher stock and real estate values and also by housing turnover. Rapid recent growth in the latter areas created extra one time needs and spending, and has pushed the reported savings rate to slightly negative levels.

Indeed, even employment growth creates some spending that is transitory in nature, or more the product of consumer psychology than of changes in income. As an example, besides allowing a family new credit card and borrowing availability, a new job tends to boost spending on job-related needs like wardrobe and auto purchases. It is not a coincidence that total inflation-adjusted consumption of clothing and autos rose 7.2 percent and 8.8 percent respectively last year, helped in part by the newly hired. Employment growth also improves consumer confidence and boosts spending by that channel, also.

There was some "one-time" or transitory consumption in CY 1998 that was driven by the housing market also. New and existing home sales grew by 13.1 percent to record levels in 1998, the highest growth since 1983. The higher turnover has accelerated one time "investment type" spending on home furnishings, tools and other house-related expenditures. Furniture, appliances, other durable furnishings, and semidurable furnishings all had real growth last year of 5.9 percent to 7.2 percent, considerably higher than the overall consumption growth rate of 4.8 percent.

As long as the stock market stays up, real estate values don't fall, housing turnover remains rapid, and employment gains continue, consumer spending will continue to show strong growth in CY 1999. Should one or more of these factors fail, some slowdown seems inevitable. How sharp that slowdown might be is an open question. Most economic forecasters are still predicting strong consumption growth in CY 1999.

Manufacturing

Ohio is still a manufacturing state. Yes, manufacturing is now only about 20 percent of all wage and salary jobs in the state, and yes, manufacturing is actually third in employment, trailing both services and trade (wholesale and retail combined). However, Ohio still gets more than 27 percent of its gross state product (GSP) from manufacturing, good for a rank of fifth in the nation. Manufacturing GSP in Ohio is far ahead of services GSP, despite the fact that manufacturing employs fewer people. Furthermore, although this is harder to measure, it stands to reason that a lot of Ohio's competitive advantage is in manufacturing, where the state has a long history, and where a lot of its technical know-how resides.

So how is U.S. manufacturing doing? Not as well as the economy as a whole. Employment has dropped steadily since March 1998, and manufacturing exports have fallen, due to weak foreign economies (particularly in Asia) and the strong dollar. Last year for the first time since 1991 industrial output grew by less than GDP. The prospect for further slowing is strong: weak exports, lower profits, and eventually slowing investment will have a cumulative effect the next two years. WEFA is projecting that industrial production will fall from 3.7 percent in 1998 to 1.1 percent in 1999, and virtually flat at 0.1 percent in 2000.

The prediction in the preceding paragraph of "eventually slowing investment" requires some explanation and/or defense. Business investment rebounded strongly in the fourth quarter, rising 16.7 percent after declining 0.7 percent in the third quarter. Investment growth for CY 1997 and CY 1998 has been quite strong. Nevertheless there are increasing signs that not just a slowing to "normal" investment rates but a corrective cycle is a medium term risk. This was highlighted by Fed Chairman Greenspan's testimony to the House Ways and Means Committee January 20, where he said, "To date, businesses' evident pricing power has been scant. Either that would change and inflation would begin to mount or, if costs could not be recouped, capital outlays might well be cut back. Moreover, the underutilized production capacity and pressure on the domestic profit margins, especially among manufacturers, are likely to rein in the rapid growth of new capital investment. With corporations already relying increasingly on borrowing to finance capital investment, any evidence of a marked slowing in corporate cash flow is likely to induce a relatively prompt review of capital budgets." In short, investment in manufacturing has added to productive capacity faster than output can keep up with. If producers cannot raise output prices, it seems likely that the investment spending will slow.

What all this seems to point to is some continued slowing in manufacturing. Thus, while the U.S. economy is looking stronger for CY 1999, Ohio may lag national performance somewhat. ❑

Status of the General Revenue Fund

REVENUES

— Frederick Church

As we mentioned in the *Fiscal Overview*, there are two timing issues that make the numbers for total tax revenue and total non-federal revenue very misleading. The corporation franchise tax was $130.7 million below estimate in January. While we expect franchise tax revenues to finish the year somewhat below estimate, it is certain that most of that $130 million deficit will be made up in February. Furthermore, OBM's estimates anticipated that $627.8 million in FY 1998 budget surplus would be transferred from the Income Tax Reduction Fund (ITRF) to the GRF in January, to pay the GRF's share of the revenue loss from the 9.34 percent across the board rate cut that was triggered by the surplus. That transfer did not occur. There was also an expected $25 million transfer from a bond fund, as repayment for a GRF transfer earlier in the year, that did not occur. Put these three things together and you have January results that understate revenue by roughly $780 million. For that reason, while we report the monthly and year-to-date results in Tables 2 and 3, we urge caution in interpreting them.

Table 2
General Revenue Fund Income
Actual vs. Estimate
Month of January, 1999
($ in thousands)

REVENUE SOURCE	Actual	Estimate*	Variance
TAX INCOME			
Auto Sales	$40,984	$47,775	($6,791)
Non-Auto Sales & Use	533,633	546,825	(13,192)
Total Sales	$574,617	$594,600	($19,983)
Personal Income	$908,195	$894,297	$13,898
Corporate Franchise	25,018	155,722	(130,704)
Public Utility	110	0	110
Total Major Taxes	**$1,507,940**	**$1,644,619**	**($136,679)**
Foreign Insurance	$50	$0	$50
Domestic Insurance	3	0	3
Business & Property	32	70	(38)
Cigarette	21,938	22,869	(931)
Soft Drink	0	0	0
Alcoholic Beverage	3,641	3,640	1
Liquor Gallonage	3,306	2,338	968
Estate	4,089	2,100	1,989
Racing	0	0	0
Total Other Taxes	$33,059	$31,018	$2,041
Total Taxes	**$1,540,999**	**$1,675,636**	**($134,637)**
NON-TAX INCOME			
Earnings on Investments	$0	$0	$0
Licenses and Fees	3,512	4,600	(1,088)
Other Income	7,305	8,775	(1,470)
Non-Tax Receipts	$10,817	$13,375	($2,558)
TRANSFERS			
Liquor Transfers	$3,000	$4,000	($1,000)
Budget Stabilization	0	0	0
Other Transfers In	3,335	652,800	(649,465)
Total Transfers In	$6,335	$656,800	($650,465)
TOTAL INCOME less Federal Grants	**$1,558,150**	**$2,345,811**	**($787,661)**
Federal Grants	$255,527	$294,680	($39,153)
TOTAL GRF INCOME	**$1,813,678**	**$2,640,491**	**($826,813)**

* July, 1998 estimates of the Office of Budget and Management.

Detail may not add to total due to rounding.

Personal Income Tax

Most of the income tax news looks good. Collections are $44.2 million over estimate, and have increased by 7.8 percent from last year. A serpent has entered the garden, in the guise of an unexpected shortfall in employer withholding. January withholding fell $38.6 million short of the estimate, falling by 1.0 percent from January collections last year. As of the end of December, withholding was $0.7 million below the estimate — dead even, for all practical purposes. The subsequent shortfall is worrisome but not conclusive. As has often been the case with the income tax over the past couple of years, we have hypotheses but no firm answers. One possibility is that this year's shortfall is driven by a lack of the bonus and option income that has been pushing up collections over the last couple of years. We

Table 3
General Revenue Fund Income
Actual vs. Estimate
Fiscal Year-to-Date 1999
($ in thousands)

REVENUE SOURCE *TAX INCOME*	Actual	Estimate*	Variance	FY 1998	Percent Change
Auto Sales	$416,104	$415,071	$1,033	$407,613	2.08%
Non-Auto Sales & Use	2,911,386	2,927,705	**(16,319)**	2,783,288	4.60%
Total Sales	$3,327,489	$3,342,776	**($15,287)**	$3,190,901	4.28%
Personal Income	$3,902,322	$3,858,119	**$44,203**	$3,618,596	7.84%
Corporate Franchise	29,943	176,957	(147,014)	188,530	-84.12%
Public Utility	202,069	229,500	**(27,431)**	229,593	-11.99%
Total Major Taxes	$7,461,823	$7,607,352	($145,529)	$7,227,619	3.24%
Foreign Insurance	$148,382	$136,500	$11,882	$146,909	1.00%
Domestic Insurance	42	237	(195)	438	-90.41%
Business & Property	169	668	(499)	480	-64.87%
Cigarette	160,715	161,568	(853)	160,829	-0.07%
Soft Drink	0	0	0	0	-25.00%
Alcoholic Beverage	31,010	30,316	694	30,259	2.48%
Liquor Gallonage	16,939	16,747	192	16,695	1.46%
Estate	61,943	49,875	12,068	51,808	19.56%
Racing	0	0	0	0	#N/A
Total Other Taxes	$419,200	$395,912	$23,288	$407,418	2.89%
Total Taxes	**$7,881,023**	**$8,003,264**	**($122,241)**	**$7,635,037**	**3.22%**
NON -TAX INCOME					
Earnings on Investments	$85,270	$57,500	$27,770	$65,400	30.38%
Licenses and Fees	19,723	23,380	(3,657)	21,471	-8.14%
Other Income	54,142	58,493	(4,351)	63,216	-14.35%
Non-Tax Receipts	$159,134	$139,373	$19,761	$150,087	6.03%
TRANSFERS					
Liquor Transfers	$51,000	$49,000	$2,000	$50,000	2.00%
Budget Stabilization	0	0	0	$0	#N/A
Other Transfers In	19,648	671,148	(651,500)	32,932	-40.34%
Total Transfers In	$70,648	$720,148	($649,500)	$82,932	-14.81%
TOTAL INCOME less Federal Grants	**$8,110,804**	**$8,862,785**	**($751,981)**	**$7,868,057**	**3.09%**
Federal Grants	$2,009,342	$2,071,102	($61,760)	1,951,107	2.98%
TOTAL GRF INCOME	**$10,120,146**	**$10,933,887**	**($813,741)**	**$9,819,163**	**3.07%**

* July, 1998 estimates of the Office of Budget and Management.

Detail may not add to total due to rounding.

know that businesses have changed the way that they compensate employees, moving away from wage increases to bonuses, profit sharing payments, and stock options. We know that these changes have affected Ohio withholding tax revenue. We don't yet know the magnitude — it seems plausible that reduced bonus, profit sharing, and option income could be enough to cause a $38 million shortfall, but we cannot prove it.

The components other than withholding look strong. Quarterly estimated payments are $77.5 million above the estimate, and annual return payments are $13.7 million above. The final estimated payment against tax year 1998, due January 15th and collected in December and January, was $511.2 million, or $76.2 million above the estimate of $435 million. (To lend some perspective to these numbers, we note that in FY 1987 quarterly estimated payments for the entire year were $528.7 million.) Generally, a final estimated payment for a tax year that is so far above the forecast is a sign that taxpayers have done a rough calculation of their liability and found out that it was higher than they initially expected. So, they make a big final estimated payment and/or a big annual return payment. A strong final estimated payment tends to be the harbinger of a good filing season, meaning one where revenues outstrip the estimates. LBO is expecting strong annual returns and low refunds for this filing season. The question is, how big will the overage be, and how much of the overage will be offset by low withholding?

It should come as no surprise that we attribute much of the overage in estimated payments to capital gains. Ohio is not a huge player in capital gains, at least in comparison to states like New York and California, but even for us the increase in gains is enough to have a huge impact on tax revenues.[2] Unfortunately, the latest federal tax data that we have is from tax year 1996, but even that data shows an 84 percent increase in Ohio capital gains from tax year 1994, and an increase of more than 51 percent from tax year 1995 to tax year 1996 alone. Rough LBO calculations suggest that the increase from tax year 1994 to tax year 1996 brought in an additional $165 million in tax revenue for 1996 (FY 1997). Current numbers may be even bigger. Conversations with the Congressional Budget Office (CBO) and officials in other states lead us to believe that in tax year 1997, capital gains rose by anywhere from 45 percent to 70 percent above tax year 1996 levels, and that tax year 1998 growth is anywhere from 15 percent to 30 percent. Assuming growth for Ohio of 50 percent in tax year 1997 and 20 percent in tax year 1998 leads to an additional $320 million in tax revenue over and above the tax year 1996 amount, or $485 million over the tax year 1994 amount. In other words, in FY 1999 Ohio may be getting $485 million more in tax revenue from capital gains than it did in FY 1995.

Sales and Use Tax

Aside from the income tax, the other major taxes have faltered somewhat. The non-auto sales and use tax is $16.3 million below estimate, largely on the basis of a $13.2 million January shortfall. The holiday selling season did not generate enough activity to make the estimate. Preliminary indications are that February collections will not make the estimate either. If so, then the hypothesis that holiday sales were merely "pushed back" from December into January post-Christmas sales does not hold up. This could be the sign of an eventual year-end shortfall in the sales tax for FY 1999, something that seemed unlikely at the end of December.

This does not jibe well with the following quote from the January 20th Federal Reserve ***Beige Book*** for the 4th District, which includes Ohio: "What began as a somewhat sluggish holiday shopping season, rebounded sharply by year's end. Overall, holiday retail sales were generally characterized as strong and that strength appears to have continued after the Christmas holiday…" We are unclear as to what is behind the sluggish sales tax performance at this point.

The auto sales tax had a bad January, shaving the year-to-date overage down to an almost imperceptible $1.0 million. However, poor January sales were probably the result of bad weather in the first half of the month. Auto sales are expected to bounce back in February.

Non-Tax Revenue

The state is getting a boost in non-tax revenues. Discounting the shortfall in transfers, non-tax revenue is $21.8 million over estimate, led by a $27.8 million overage in investment earnings. However, federal grants plummeted in January, falling $39.2 million below estimate. Year-to-date federal revenues are $61.8 million short of the forecast, which is actually moving closer to what one might expect given the magnitude of the underspending in human services programs. ❑

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[1] This also distorts year-to-year comparisons somewhat. At first blush it might seem that it does not, since the same thing happened in FY 1998. The transfer was originally estimated to take place in January but did not happen until February. The difference is that in FY 1998 the transfer amount was only $235.3 million, while the FY 1999 transfer will be $627.8 million. So, the delayed transfer in FY 1999 has a much greater impact.

[2] IRS Statistics of Income (SOI) data indicates that Ohio capital gains are less than 3 percent of the national total.

DISBURSEMENTS

*— Jeffrey E. Golon**

As we joined in our mind's eye two images — one of the steady FY 1999 parade of monthly underages, the other of the just-posted tiny $4.8 million January underage — a third image popped out, that of a baby first learning to crawl, albeit slowly and tentatively, as a way to investigate its world. And that was exactly the effect that January's disbursements had on the state's year-to-date underage. It permitted the parade of monthly underages to march on, but its forward momentum was reduced to a barely perceptible crawl. And this crawl reflected a stalemate that existed at month's end after a large force of underages had run head-on into an almost equally powerful force of overages.

Table 4
General Revenue Fund Disbursements
Actual vs. Estimate
Month of January, 1999
($ in thousands)

USE OF FUNDS			
PROGRAM	Actual	Estimate*	Variance
Primary & Secondary Education (1)	$452,965	$404,110	$48,855
Higher Education	$144,334	$158,253	($13,919)
Total Education	$597,299	$562,363	$34,936
Health Care/Medicaid	$366,468	$422,099	($55,631)
Temporary Assistance to Needy Families	$71,328	$93,037	($21,709)
General/Disability Assistance	$3,938	$4,907	($969)
Other Welfare	$33,274	$42,584	($9,310)
Human Services (2)	$100,152	$86,680	$13,472
Total Welfare & Human Services	$575,160	$649,308	($74,148)
Justice & Corrections	$166,556	$131,381	$35,175
Environment & Natural Resources	$9,086	$9,150	($64)
Transportation	$1,910	$2,534	($624)
Development	$6,405	$6,936	($531)
Other Government (3)	$24,447	$21,300	$3,147
Capital	$318	$273	$45
Total Government Operations	$208,722	$171,574	$37,148
Property Tax Relief (4)	$675	$3,386	($2,711)
Debt Service	$26,869	$26,898	($29)
Total Program Payments	**$1,408,725**	**$1,413,529**	**($4,804)**
TRANSFERS			
Local Govt Distribution	$0	$0	$0
Budget Stabilization	$0	$0	$0
Other Transfers Out	$1,570	$0	$1,570
Total Transfers Out	$1,570	$0	$1,570
TOTAL GRF USES	**$1,410,295**	**$1,413,529**	**($3,234)**

(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, 1998 estimates of the Office of Budget and Management.

Detail may not add to total due to rounding.

January Variance. Excluding transfers, January closed with a microscopically sized negative disbursement variance of $4.8 million, creating the appearance that it was a calm and quiet month for disbursements. Peering below the surface exploded the illusion, as we discovered a much different picture in which negative and positive disbursement forces battled to the point of a virtual dead heat. The negative disbursement forces were led by the Welfare and Human Services program category ($74.1 million), with their major power supplied by Healthcare/Medicaid ($55.6 million) and the Temporary Assistance to Needy Families (TANF) program ($21.7 million). At work here were clearly spending constraints exercised by declines in certain human services caseloads as well as some timing-based delays in a few of Medicaid's service categories. In control of the positive disbursement forces massed on the other side of January's spending were the Education and Government Operations program categories ($72.1 million), essentially driven by timing-based overages provided by the departments of

Table 5
General Revenue Fund Disbursements
Actual vs. Estimate
Fiscal Year-to-Date 1999
($ in thousands)

USE OF FUNDS

PROGRAM	Actual	Estimate*	Variance	FY 1998	Percent Change
Primary & Secondary Education (1)	$2,927,389	$2,966,953	($39,564)	$2,705,785	8.19%
Higher Education	$1,373,637	$1,369,251	$4,385	$1,307,824	5.03%
Total Education	$4,301,026	$4,336,204	($35,178)	$4,013,609	7.16%
Health Care/Medicaid	$2,988,888	$3,183,488	($194,600)	$2,984,134	0.16%
Temporary Assistance to Needy Families	$497,832	$597,720	($99,888)	$546,567	-8.92%
General/Disability Assistance	$33,239	$43,393	($10,154)	$34,447	-3.51%
Other Welfare	$250,152	$312,857	($62,705)	$272,205	-8.10%
Human Services (2)	$718,645	$720,026	($1,382)	$722,471	-0.53%
Total Welfare & Human Services	$4,488,755	$4,857,485	($368,730)	$4,559,824	-1.56%
Justice & Corrections	$979,015	$1,030,745	($51,730)	$937,882	4.39%
Environment & Natural Resources	$88,875	$84,334	$4,540	$88,109	0.87%
Transportation	$19,236	$15,873	$3,363	$14,143	36.00%
Development	$74,885	$74,951	($66)	$73,081	2.47%
Other Government (3)	$235,300	$268,703	($33,403)	$225,955	4.14%
Capital	$2,452	$3,520	($1,068)	$2,773	-11.56%
Total Government Operations	$1,399,763	$1,478,126	($78,363)	$1,341,943	4.31%
Property Tax Relief (4)	$536,260	$538,489	($2,229)	$515,563	4.01%
Debt Service	$118,372	$118,451	($79)	$100,055	18.31%
Total Program Payments	**$10,844,175**	**$11,328,755**	**($484,579)**	**$10,530,994**	**2.97%**
TRANSFERS					
Capital Reserve	$0	$0	$0	$0	——
Budget Stabilization	$44,184	$44,184	($0)	$34,400	28.44%
Other Transfers Out	$975,149	$967,560	$7,589	$729,237	33.72%
Total Transfers Out	$1,019,333	$1,011,744	$7,589	$763,637	33.48%
TOTAL GRF USES	**$11,863,508**	**$12,340,499**	**($476,990)**	**$11,294,631**	**5.04%**

(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, 1998 estimates of the Office of Budget and Management.

Detail may not add to total due to rounding.

Education ($50.7 million) and Rehabilitation and Correction ($32.6 million). Numerous other small underages and overages were also tossed into the disbursement mix, but by month's end, both forces had largely cancelled one another out, leaving neither clearly in command.

Table 4, on the preceding page, provides a more detailed picture of this January disbursement battle by program category.

Year-to-Date Variance. The state's year-to-date disbursement picture can be pretty aptly painted with a single piece of our budgetary jargon — underspending. Although January posted a barely visible underage of $4.8 million, it still managed to nudge the negative year-to-date disbursement variance, excluding transfers, up to yet another high-water mark for FY 1999: $484.6 million. Upon closer examination of the numbers, and none too surprising, was the key role played by the Welfare and Human Services program category ($368.7 million) in this year-to-date underage. If we were looking to point to a single agency of state government as the dominant factor in that year-to-date underage, one need go no further than the Department of Human Services, whose budget is the sole occupant of four of the Welfare and Human Services program category's five components. The sum of the year-to-date underages in these four components alone — HealthCare/Medicaid ($194.6 million) + the Temporary Assistance to Needy Families (TANF) program ($99.9 million) + General/Disability Assistance ($10.2 million) + Other Welfare ($62.7 million) — totaled $367.4 million. This meant that three-quarters, or 75.8 percent, of the state's year-to-date negative disbursement variance was traceable exclusively to the Department of Human Services. While some of these departmental underages were clearly timing-based, particularly in the case of the Other Welfare component, a significant portion represented true savings that were being generated as a result of declining caseloads in certain service areas of the Medicaid, TANF, and General/Disability Assistance programs.

It would be remiss of us, if, in closing this brief overview of the state's year-to-date disbursement picture, we failed to acknowledge the role of the "wild card" played by the Property Tax Relief program category throughout the first half of FY 1999. If one were to examine the year-to-date variances by program category, which appear in Table 5 on the previous page, Property Tax Relief looks to be cast as nothing more than a bit player in the $484.6 million underage, as evidenced by a miniscule negative disbursement variance of $2.2 million. If, however, the reader had been regularly following the state's first six months of FY 1999 disbursement activity, one already knew this January impression was incorrect. From August through December, Property Tax Relief was in fact a major character, as it swung wildly from one large monthly underage to a large monthly overage and back again. Although these disbursement variances loomed significant at the end of each of those prior months, they were merely timing-based oscillations that had essentially resolved themselves by the time we hit January.

Federal Money. Of the year-to-date underspending in the TANF and Medicaid programs combined ($294.5 million), 58.7 percent, or $172.8 million, was in the federal share of these two human services programs that are jointly funded by the state and federal government. Furthermore, a fairly sizeable portion of this underspending in the federal share — $113.3 million (65.6 percent) — was exclusively attributable to Medicaid. Once the federal money associated with TANF and Medicaid was backed out, the year-to-date underspending in non-federal state money was reduced from $484.6 million down to $311.8 million.

And before we move on, let's recite our now-cliched budget mantra with regard to this specific pile of federal money. Any federal TANF money unspent at fiscal year's end really represents money the state will have earned by meeting its required maintenance of effort (MOE). On the other hand, an underage in Medicaid really signals a loss of anticipated revenue since the state will not have spent the money necessary to earn financial reimbursement from the federal government.

With our spending overview completed, we will now take the reader for a ride through a selection of the disbursement activities that caught our attention.

Primary & Secondary Education

Education. The Department of Education closed January with a $50.7 million overage, 12.9 percent above the estimate for the month. This was only the second overage posted by the department in FY 1999, the first — $32.5 million — having shown up just last month as a result of rather massive, but expected, overspending in the nonpublic administrative cost reimbursement and school bus purchase allowance programs. The combination of these two consecutive monthly overages — $83.2 million — yanked the department's prior year-to-date underspending from a high-water mark of $122.7 million, registered in November, all the way down to $39.4 million by January's end.

The October Count. The state's school foundation (SF-3) payments for a given fiscal year are based on the so-called October count for that year, which captures the average daily membership (ADM) of students during the first full week of classes in October, and are disbursed to school districts twice a month. The biennial appropriations that support the school foundation program are built by projecting historical trends into the future. When it comes to disbursing actual school foundation funding for the first six months of a fiscal year, payments are generally based on each school district's ADM count from the previous year. This lag is usually created by the department's need to work with school districts for another two-to-three months to improve the accuracy of the October count data. In FY 1999, the second of two January school foundation payments was the first to be based on the current year October count.

As a result of the school funding reform enacted by the 122nd General Assembly, state support for all school children was directed to the school district in which they reside. Prior to FY 1999, state support was disbursed directly to the entity that actually educated a particular child, regardless of whether that was the child's school district of residence or not. Many children, especially those receiving special and/or vocational education, are educated by school districts other than the one in which they reside or by an educational service center. Starting with FY 1999, school districts were required to report all their resident students, including those educated by other school districts or educational service centers, with the state then transferring funds on behalf of a resident school district in instances where they were contracting with other school districts and/or educational service centers to educate some of their students.

Since this was the first time school districts were required to report data in such a fashion, there was some confusion as to how to report those "contractual students." This state of affairs has in turn called into question the accuracy of the current year's October count data that was first used to make the second of two January 1999 school foundation payments. Since that discovery, the department has been working with school districts to find and correct any data problems in relation to the counting of contract students, with the expectation that any necessary fixes will be in place for the school foundation payments scheduled to be made in late March or early April.

DPIA. The Disadvantaged Pupil Impact Aid (DPIA) program — funded entirely from line item 200-520 — accounted for almost all of the department's $50.7 million January overage by throwing in a positive monthly disbursement variance of $47.7 million. This overage was partially caused by: (1) an expected catch-up DPIA payment in January; and (2) an inadvertent mistake of double counting kindergarten ADM in the all-day and everyday kindergarten funding calculation. Prior to January, FY 1999 DPIA disbursements had been consistently landing under the monthly estimate. And, as we have noted in the two previous issues of ***Budget Footnotes***, timing was playing a key role in the DPIA program's underspending.

The 122nd General Assembly restructured the program to include funding for all-day kindergarten, K-3 class size reduction, and safety and remediation programs, and increased FY 1999 DPIA funding up to $386.6 million, a healthy 37.5 percent bump over the FY 1998 appropriation of $281.2 million. Each school district's first quarter FY 1999 payments, however, were based on their FY 1998 funding level. That was why the program's year-to-date spending was under the estimate by $16.3 million at the close of December. As a result, the department planned to make, and then made, a catch-up payment in January. Unfortunately, kindergarten ADM numbers were inadvertently counted twice in the calculation of the January DPIA disbursements. The mistake was discovered after-the-fact and subsequently corrected, with means that the program will most likely post a negative disbursement variance for the month of February.

Other January Overages. As expected, the Post-Secondary/Adult Vocational Education program (line item 200-514) posted a $7.2 million overage in January. As one may recall from the previous issue of ***Budget Footnotes***, the program's second quarter payment, estimated in excess of $5 million, did not occur in December as originally planned. Instead, it was disbursed in January. The desegregation costs program (line item 200-534) also landed a $4.6 million overage in January. This was caused by the fact that the $5 million set-aside for the Cincinnati Magnet School Program was disbursed earlier than originally planned.

The state's desegregation costs program provides funding to pay the state's share of the cost of court-ordered desegregation cases and associated legal fees. Funds received by a district for this purpose are used for transportation costs and other court-directed purposes associated with desegregation efforts. State funds pay approximately 50 percent of the local cost of court-ordered desegregation. The bulk of the program's total FY 1999 appropriation ($50.4 million) is earmarked for the Cleveland City Schools ($38.2 million). Dayton City Schools is also scheduled to receive at least $4.5 million in funding from the program.

Year-to-date Underages. As noted earlier, at January's end, the department's year-to-date spending was still $39.4 million, or 1.4 percent, under the estimate. The year-to-date underage was led by the pupil transportation program (line item 200-502), which posted a $33.7 million underage as expected. The program's $27 million set-aside for handicapped transportation was not disbursed in December, as was noted in our previous issue of ***Budget Footnotes***, and may not be disbursed until February.

Other notable year-to-date underages were as follows: (1) $6.9 million in line item 200-540, Special Education Enhancements; (2) $6.7 million in line item 200-545, Vocational Education Enhancements; (3) $5.2 million in line item 200-504, Special Education; (4) $6.8 million in line item 200-507, Vocational Education; (5) $4.2 million in line item 200-558, Emergency Loan Interest Subsidy; (6) $3.4 million in line item 200-546, Charge-off Supplement; and (7) $2.9 million in line item 200-547, Power Equalization.

Among other things, the special education enhancements program (line item 200-540) provides funding for students educated by county boards of mental retardation and developmental disabilities and for preschool special education. The vocational education enhancements program (line item 200-545) mainly contains funding for 49 joint vocational schools. Most of the funds under these two line items are distributed on a per unit basis. Since units need to be formed and approved by the department before actual disbursements can be made, it is not particularly surprising to see underspending in these two programs at this time.

Due to the delay in correcting the data of a few school districts, the department has yet to perform the final FY 1998 foundation payment (SF-12) adjustments and is not likely to until March. And until that happens, the prior years' encumbrances that are trapped in line items 200-507, Vocational Education, and 200-504, Special Education, will not be disbursed. These two line items were part of the school foundation formula (SF-12) in FY 1998, but, beginning with FY 1999 funding for school districts' special and vocational education programs was merged into line item 200-501, Base Cost Funding.

Finding underages in three newly created programs (emergency loan interest subsidy, charge-off supplement, and power equalization) was not surprising either. There was no disbursement activity in the charge-off supplement and power equalization programs until halfway through last October. The emergency loan interest subsidy program, on the other hand, appeared to be snagged by a statutory problem. While state law required the department to use the loan subsidy to make payments based on the calendar year, the emergency school loans were obtained on the fiscal year basis. It also appeared that the original legislative intent was to make payments based on the current fiscal year instead of the preceding calendar year as currently specified by the law. The department is not planning to make any payments until the 123rd General Assembly clarifies the program statute. And until that happens, we are unlikely to witness any disbursement activity in this new loan subsidy program.

Health Care/Medicaid

In January, the Medicaid program fired off yet another one of its all too familiar monthly underages for FY 1999 by posting a negative disbursement variance of $55.6 million, 13.2 percent below the estimate. This negative disbursement variance marked the second largest monthly underage for the year, which to date, have ranged from a low of $7.6 million in October 1998 to a high of $59.6 million in November 1998. As a result of this negative monthly disbursement variance, Medicaid's year-to-date underage grew to $194.6 million, which was 6.1 percent below the estimate. (For more detail on monthly and year-to-date Medicaid spending, see Table 6, which is located on the following page.)

A hidden hand within the huge January variance was the element of timing, which had strangled the expected fee-for-service payments in some Medicaid service categories and temporarily restricted planned disbursement activity. We briefly scrutinized the available Medicaid data and discerned that the underspending in areas related to hospital acute care, physician services and prescription drugs was due to the fact that some claims will be paid a little later than was originally assumed. If one were to factor out those timing-based underages — approximately $22.6 million — then Medicaid's year-to-date negative disbursement variance would have been more like $172.0 million, as opposed to the actual $194.6 million.

Table 6

Service Category	January '99 Actual	Estimate	Variance	Percent Variance	Year-to Date Spe Actual** thru' Jan.	Estimate** thru' Jan.
Nursing Homes	$167,493,558	$175,964,448	($8,470,890)	-4.8%	$1,158,538,536	$1,202,797,399
ICF/MR	$29,322,652	$29,045,143	$277,509	1.0%	$201,238,774	$198,605,950
Hospitals	$74,460,005	$87,650,001	($13,189,996)	-15.0%	$682,330,502	$682,543,203
Inpatient Hospitals	$56,790,715	$68,287,578	($11,496,863)	-16.8%	$521,281,762	$529,877,042
Outpatient Hospitals	$17,669,290	$19,362,423	($1,693,133)	-8.7%	$161,048,740	$152,666,161
Physicians	$17,769,699	$21,454,456	($3,684,757)	-17.2%	$159,056,743	$164,861,259
Prescription Drugs	$16,944,937	$23,970,033	($7,025,096)	-29.3%	$309,989,985	$322,331,684
Payments	$49,127,529	$54,902,239	($5,774,709)	-10.5%	$405,817,506	$411,733,865
Rebates	$32,182,592	$30,932,206	$1,250,387	4.0%	$95,827,521	$89,402,181
HMO	$25,323,773	$45,212,212	($19,888,439)	-44.0%	$205,360,664	$316,317,191
Medicare Buy-In	$10,433,629	$9,861,929	$571,700	5.8%	$71,183,856	$66,055,004
All Other***	$25,710,614	$28,941,239	($3,230,625)	-11.2%	$202,179,664	$229,982,130
TOTAL	$367,458,868	$422,099,462	($54,640,594)	-12.9%	$2,989,878,723	$3,183,493,822
CAS	$366,467,865		($55,631,597)	-13.2%	$2,988,887,721	
Est. Federal Share	$213,971,299	$245,788,517	($31,817,218)		$1,741,006,380	$1,853,748,453
Est. State Share	$153,487,569	$176,310,945	($22,823,376)	-12.9%	$1,248,872,343	$1,329,745,369

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

** Includes spending from FY 1998 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.

We would like to alert the reader that our usual selective monthly look-see at some of the service categories hidden below Medicaid's bottomline will undergo a brief period of bed rest, as we turn our attention to the stress, the strains, and the demands of the state's biennial budgeting process. This is done in lieu of the risk of the writers themselves needing acute care services. We note, however, that we will strive in the next few months to at least assemble the service category disbursement detail typically found in Table 6.

TANF

In January, disbursements from the Temporary Assistance to Needy Families (TANF) program continued the established FY 1999 pattern of running in under the estimate. An additional $21.7 million in monthly underspending was thrown into the mix, which blew the year-to-date negative disbursement variance up to $100 million ($99.9 million to be more exact). The January underage represented a departure from the monthly estimate of 23.3 percent, while the year-to-date underage was 16.7 percent off the estimated mark. The year-to-date variance was composed of: (1) $33.7 million from the state's Maintenance of Effort share; (2) $59.5 million from the state's federal TANF grant; and (3) the remainder from unspent prior years' encumbrances.

This month's negative disbursement variance was due largely to the continued decline in the program's cash assistance caseload. The number of cash recipients dropped by over 10,000 in January, and has fallen by a little over 57,000 recipients since the beginning of the fiscal year, a dive of 16.8 percent — closely paralleling the program's rate of underspending.

General/Disability Assistance

The General/Disability Assistance (GA/DA) program registered January disbursements that were almost $1.0 million, or 19.7 percent, below the estimate. This then pushed the program's year-to-date negative disbursement variance up to $10.2 million, which was 23.4 percent below the estimate. A large chunk of the program's year-to-date variance has been, and continues to be, due to the fact that a planned $6-plus million September disbursement to settle the Taber lawsuit has yet to occur, and, by all appearances, does not look like it will happen anytime soon. (For a more detailed discussion of the Taber lawsuit, see our July/August, 1998 issue.)

A steady decline in DA caseload accounted for the remainder of the program's underage. At month's end, the DA caseload stood at about 9,900 recipients, down from approximately 11,500 at the beginning of the fiscal year, a drop off of 1,600 recipients, or almost 14.0 percent. Part of that reduction in the number of DA recipients was attributable to rule changes introduced by welfare reform. As a result, the work history requirements for two-parent families were removed, thus making it easier for these families to qualify for Ohio Works First assistance, shifting individuals who would otherwise have been eligible for the GA/DA program into the TANF program.

Justice & Corrections

Through the month of January, the Justice and Corrections program category was holding a negative year-to-date disbursement variance of $51.7 million, a fall of $35.2 million from last month when the program category's year-to-date underage hit $86.9 million. That swan dive from December was attributable to an expected tsunami-like monthly overage hurled in from the Department of Rehabilitation and Correction (DRC). At month's end, the three featured players in the program category's year-to-date underspending were, in order of magnitude, as follows: (1) DRC ($37.7 million); (2) the Judicial Conference of Ohio ($7.7 million); and (3) the Department of Youth Services ($5.1 million). We examined some of the program category's monthly and year-to-date disbursement activity a little more closely and produced the relatively brief stories below.

Attorney General. Year-to-date, the Office of the Attorney General has posted a relatively small overage of around $826,000, which is in excess of estimated disbursements by 2.7 percent. Over the course of the last two months, the more notable disbursement events have been occurring below the surface in their budget-driving, $47.6 million operating expense line item (055-321). In December and January, the Attorney General registered overages of approximately $412,000 and $333,000, respectively, in a line item that disburses a monthly average of around $3.7 million, with anywhere from 80 percent to 90 percent of that spending for payroll costs.

Two principal forces were at work here. First, the Attorney General has transferred the payroll costs associated with around 20 positions into its GRF budget from Fund 419, Claims Section. The latter fund receives the Attorney General's cut of the action for collecting claims due to various state agencies (9.0 percent of the amount collected) and this money is in turn used to fund the Attorney General's revenue recovery actions as well as to support officewide operating expenses.

Over time, some state agencies, most specifically the Bureau of Workers' Compensation and the Department of Taxation, have enhanced their capabilities to do these collections in-house. As a consequence, the Attorney General has lost some revenue it would have otherwise collected and Fund 419, at least in the short-term, has experienced what might best be described as a cash flow problem. Given that, these transferred positions will most likely sit in the Attorney General's GRF budget for the entire third quarter and perhaps through the fourth quarter as well.

Fund 419's healthy cash flow has traditionally been seen by Attorneys General as an attractive and easy way to supplement their GRF budget. The need to transfer some positions, even for a short period of time, suggests that the Attorney General has hit a financial dilemma that will most likely have to be addressed by the state legislature during its upcoming deliberations over the biennial operating budget for fiscal years 2000 and 2001.

The second, and more ephemeral, force in the line item's disbursement pattern was a late December payroll that landed in early January and not in December as was originally assumed.

Rehabilitation & Correction. The lead story for the Department of Rehabilitation and Correction's (DRC) disbursements was an initially eye-popping $32.6 million monthly overage. This rather large dollar amount, however, was quickly put in context if one were to recall our discussion of the $36.4 million monthly underage that the department produced just last month. A December GRF payroll covering 14,000-plus staff did not post in the waning days of that month as originally assumed. It actually posted in very early January, which essentially guaranteed, all other things remaining the same, a monthly overage of $30-plus million. A huge chunk of what was left of the department's year-to-date underage — $37.7 million — was assumed to be timing-based and would largely sort itself out by the close of the fiscal year.

Youth Services. In our previous issue, we observed that the December disbursement estimate for the department's massive line item 470-401, Care and Custody, was $14.8 million and that the actual monthly amount disbursed was $10.5 million. This line item's $4.3 million negative disbursement variance was the primary culprit behind the department's $5.3 million monthly underage as well as its $8.4 million year-to-date underage. The department attributed that underspending to the timing of a December payroll, which was going to post in very early January as opposed to the waning days of December as was originally assumed. As the department's two-week payroll averages $3.6 million, it was clearly the primary factor behind December's underspending. As a result of this payroll shifting from one month to the next, an overage of $3.6 million was anticipated in January, at least as it related to the department's Care and Custody line item.

This was indeed the case. The January disbursement estimate for the line item was $10.5 million, whereas the actual amount disbursed was $13.9 million, a positive monthly disbursement variance of $3.4 million. As a result of the expected overage contributed by the Care and Custody line item, the department closed January with a positive disbursement variance of $3.3 million. This monthly overage also reduced the department's year-to-date underage to $5.1 million.

Other Government

Administrative Services. The story here remained the same. The year-to-date negative disbursement variance registered by the Other Government component of the Government Operations program category ($33.4 million) has been fueled by underspending in the Department of Administrative Services' budget ($25.1 million). The steam for the department's year-to-date underage has been delivered by: (1) lower than expected payments for rent and operating costs on state-owned buildings, including the State of Ohio Computer Center; and (2) slower than expected disbursements on computing and communications services to other state agencies. Much of this underspending, as we have noted on numerous other occasions, was generated way back in August ($9.7 million) and September ($9.2 million). Year-to-date, state building rent and operating costs has contributed $11.5 million to the department's underage, with $6.8 million alone coming from smaller than anticipated debt service payments to the Ohio Building Authority (line items 100-447 and 100-448). Four components of the department's computer and communications services program have tossed a $11.1 million underage into the mix as well: (1) Year 2000 Assistance (line item 100-430); (2) Multi-Agency Radio Communication System/MARCS project (line item 100-417); (3) Strategic Technology (line item 100-416); and (4) State of Ohio Multi-Agency Communications Systems/SOMACS (line item 100-419). ❑

**LBO colleagues developing material that anchored this include, in alphabetical order, Ogbe Aideyman, Laura Bickle, Sybil Haney, Steve Mansfield, and Wendy Zhan.*

Issues of Interest

BUDGET ISSUE SNAPSHOTS

SYBIL HANEY

As the General Assembly begins work on the Executive's proposed budget for the 2000-2001 biennium, there are several issues which cut across departmental boundaries. Three of these which will require legislative consideration during the budget deliberations are summarized below.

Union Contract Renegotiations

The current contract between the state and the Ohio Civil Service Employees Association (OCSEA) ends in February 2000. OCSEA is Ohio's affiliate of the American Federation of State, County, and Municipal Employees and represents 37,000 of the nearly 64,000 state employees. Standards and benefits offered the non-OCSEA employees are generally based on provisions of the OCSEA contract.

DAS' Office of Collective Bargaining (OCB) represents the state in labor union negotiations. For the OCSEA contract, OCB has in the past hired a consultant for renegotiations. OCB may retain services of the consultant for the upcoming renegotiations, or a staff labor attorney may be summoned for this duty. The office awaits guidance from the Governor's office, and passage of the operating budget, as to which method to use. As the expiration of the current labor contract occurs during fiscal year 2000, state agencies were required to propose budgets for the 2000-2001 biennium without knowing the fiscal impact of the upcoming negotiations. In turn, the legislature also will be taking action on the proposed budget without knowing how much to build in for negotiated salary increases.

Additional pay period for FY 2000

A total of 27 pay periods will fall in FY 2000. Usually each fiscal year has 26 pay periods; the additional pay period will create an additional expenditure for the state. State agency budget officers were not given guidelines on how to cover these costs when they prepared their budgets. As a result, some agencies are absorbing these costs in their core requests while other agencies have requested supplemental moneys to cover these costs.

This office estimates the additional expenditure for the state for one pay period to be about $135 million. This amount represents 3.8 percent of the total annual payroll of approximately $3.5 billion. Of the extra pay period amount, $70.7 million, or 52.4 percent would be paid from the GRF. [1]

Year 2000 Computer Compliance

Agencies are responsible for requesting adequate funds to cover costs of testing and equipment upgrades that are necessary for Year 2000 (Y2K) compliance. In addition, DAS' Y2K Competency Center has requested $6.8 million for the upcoming biennium to provide technical assistance and for last-minute emergency fixes. Statewide estimated costs for services and products for fiscal years 1998 and 1999 were $61 million, but costs for fiscal years 2000 and 2001 have not yet been estimated.

According to DAS, the Computer Services Division has set guidelines that require agencies that will not be compliant by June 1999 to submit contingency plans. Although many systems may not meet the

June 1999 deadline, DAS has identified a number of critical computer systems that have already passed testing for compliance. These success stories include the Department of Human Services' Client Registration Information System (CRIS-E), the mainframe systems of the Department of Taxation and the Bureau of Employment Services, and all systems of the Lottery Commission and the Department of Commerce. ❑

[1] Pay period estimates are based on DAS' payroll figures from November 7, 1998.

FROM CALIFORNIA:
"STATE SHOULD EMPLOY 'BEST PRACTICES' ON INFORMATION TECHNOLOGY PROJECTS"

SUMMARIZED BY DENNIS M. MORGAN
OHIO LEGISLATIVE BUDGET OFFICER

California has experienced a number of well publicized and very costly failures in attempting to implement major computer projects. As a result of these failures and subsequent evaluations, the state created the Department of Information Technology (DOIT). The department is responsible for developing policies and procedures, by which information technology projects are to be conceived, evaluated, bid, and deployed.

In further evaluation of information technology projects, the Legislative Analyst's Office of the California legislature issued a report in December 1998, titled "State Should Employ 'Best Practices' On Information Technology Projects." This report outlines 12 best practices that should be evaluated for implementation on state IT projects. It begins with the following:

"In this report we examine 12 specific business practices frequently used by the private sector to develop, acquire, and implement information technology. The practices fall into four basic categories procurement, project development, oversight, and contract management. We find that if state agencies use these 'best practices,' the risk of failure of an information technology project would likely be reduced. "

In the reports Conclusion and Recommendation, they "recommend that these best practices be used on state information technology projects, unless a project has unique characteristics that warrant exceptions. Specifically, we recommend that the Legislature:

a) Require the Department of Information Technology to develop and issue policies which use best practices for *new* information technology projects, but allow for exceptions to be made with justification.

b) Require the department to review *existing* information technology projects and require departments to enhance current projects, to the extent possible, by employing the appropriate best practices.

c) Hold the department accountable for implementing the use of these 12 best practices through budgetary and legislative oversight hearings."

The following is a summary of the information and recommendations made by the California Legislative Analyst's Office.

"Best Practices" for State Information Technology Projects

Procurement Process

1. Base Procurement on Best Value, Not Lowest Cost
2. Outline Business Problem, Allow Vendor to Propose Solutions

Project Development

3. Develop Smaller Projects With Milestones
4. Prioritize Project Elements Budget, Schedule, Functionality Up Front
5. Establish Measurable Objectives for the Project
6. Avoid Decisions Based Primarily on Opportunities to Enhance Federal Funding

Project Oversight

7. Require the Use of Project Management Methodology
8. Require Letter of Credit From Vendors on Larger Projects
9. Heed Advice of Oversight Consultants or Explain Why Not Applicable
10. Pay Vendor Only Upon Acceptance of Tested Project Deliverables

Contract Management

11. Write Stronger Contracts to Better Protect the State
12. Enforce the Terms of Contracts

The Concept of Best Practices In Information Technology

"Best practices" is a term used to describe generally agreed upon processes and policies that should be undertaken when purchasing and deploying IT projects in order to decrease operational and financial risk. They are strategies derived from experienced industry experts who have, through trial and error, discovered methods for design, development, and operation of computer systems which increase the chances of success and decrease risk

The table above lists the 12 "best practices" identified in this report. Following the table is a summary of the report's discussion of what each of these practices entails.

The Procurement Process

1. Base Procurement on Best Value, Not Lowest Cost

Acceptance of the lowest cost bid is a generally accepted principal in most government procurement processes. The low cost bid process was established to reduce the likelihood that bids were being awarded based on favoritism or connections. Furthermore, it made it easy to determine who had the winning bid. It is the one with the lowest cost.

However, there are significant drawbacks to this approach. First, the low cost bid process requires departments to propose technologically prescriptive solutions for a business problem the department is trying to resolve, so that all vendors' bids can be evaluated using the same criteria. Because a department specifies the particular technology, vendors are forced to provide a price on a particular solution which may not be technically feasible or may not be the best solution.

Second, the process has also resulted in vendors "low-balling" their bids but then coming back to the state with requests for additional money to cover costs not included in the bid. If the state does not approve the additional funds, the project may not perform as envisioned; if the funds are approved, the project turns out to be more expensive than anticipated.

"Best value" procurements enable a department to evaluate a bid based not solely on costs but also on other important considerations. These could include a vendor's technological solution, experience in a particular program area, the financial strength of a company, the experience of the vendor's staff, and other project components not previously included when bids were being considered. In such an approach, every vendor is made aware through the procurement documents of how the bids will be evaluated; the vendors are evaluated not only on the basis of cost but other important dimensions.

2. Outline Business Problem Then Allow Vendor to Propose Solutions

Specifically, the more technologically prescriptive the department's procurement document, then the more confined the vendor's proposal, resulting in less opportunity for alternative solutions to be bid. In addition, the state generally must accept full responsibility if the project subsequently fails because it prescribed the technological solution. Finally, if the department specifies a technological solution that ultimately does not meet its needs, a vendor can still fulfill the terms of the contract without the state necessarily obtaining a product that addresses the problem it was attempting to solve.

By contrast, if the state requires the vendor to propose the solution to a stated business problem, the risk related to offering the appropriate solution is predominantly shifted from the state to the vendor. When a vendor proposes its own solution, it is stating that a particular technology will solve the business need. As such, the state can require the vendor to take more responsibility for proposing its technical solution, should it fail.

Project Development

3. Develop Smaller Projects With Milestones

Large, multi-year projects pose significant dangers. For instance, it takes a significantly larger amount of money to put such a project back on track if a problem occurs, due to the larger initial investment of time and money. Also, it tends to take longer to acknowledge fatal problems on a lengthy project because it is difficult to walk away from an investment of years and "sunk costs" of potentially millions of dollars. In some cases, it is better to simply cancel a troubled project rather than try to fix it.

On the other hand, smaller projects with predetermined milestones, where decisions are required to be made at each milestone, make difficult decisions a little easier. For example, it is easier for IT staff to tell executives after three months of problem solving on a year long project to modify or abandon the project than it would be after investing three years.

Additionally, long project life cycles make it difficult to respond to new business needs or technological changes. For instance, a decade-long project like the welfare automation system may need significant changes to reflect changes in policy and shifts in technology. A smaller project with more discrete components can incorporate such changes easier.

4. Prioritize Project Elements Up Front

Determining the priorities between the budget, schedule, and functionality must be made at the beginning of the project to guide the project manager throughout the project's life cycle.

For example, assume that a problem occurs which could result in a delay in deploying the project and the project manager knows that it is of paramount importance that the project be done by a certain date. The manager knows he or she must either increase the budget, thereby dedicating more resources to solving the problem, or decrease the functionality in order to meet the schedule. Alternatively, if the budget is the number one priority, the manager can delay the project or reduce its functionality.

Without establishing these priorities, the project loses definition and may no longer be on schedule, on budget, or able to perform as it was intended.

5. Establish Measurable Objectives for the Project

Automation can bring efficiencies. However, a department has to establish measurable objectives for the project to avoid automating for the sake of automation. Quantifiable goals, such as establishing a target for reducing the amount of time or cost to administer the program, should be established. Without quantifiable goals and baseline data to use in assessing whether the goals have been obtained, progress and success cannot be measured. Broad goals such as "program efficiencies" must be quantified in order to measure progress.

Lack of performance standards to gauge and monitor progress makes it virtually impossible to determine whether the project has accomplished its objective. Even if a project is initiated as a result of a federal government requirement, the state should establish quantifiable goals.

Measurable objectives, combined with strong project management, will enable the evaluation of progress and increase the chances of success. Without every participant knowing what the quantifiable goals are, communication and ultimate success become more difficult.

6. Avoid Decisions Based Primarily on Funding Availability

Frequently, the federal government provides additional funds above its normal share for federally mandated programs (predominantly social services programs). These funds are often provided as an incentive for a state to implement a system or to achieve a federally determined goal, such as deploying a system by a certain date. However, a state's attempt to maximize federal funding can lead to conflicting priorities for a project. In fact, the rush to obtain the federal funding may contribute to ultimate failure if the funding priority conflicts with previously established project priorities or use of best practices. Although it is tempting to maximize the federal funding of information systems, decisions must be made based on project management guidelines to ultimately produce the most efficient and effective system.

Project Oversight

7. Require the Use of Project Management Methodology

A project management methodology is a blueprint of how the project will be administered. It includes many components which enable a project manager to administer and track progress on a project; essentially a collection of processes which have been tested and are employed to decrease the risk of operational failure and increased costs. Although some would consider the collection of these processes as common sense, many departments view them as a distraction from making progress on a project. Unfortunately, without rigorous project management, it is difficult to track expenditures and success of a project.

A project management methodology should include, among other things, development of a strategic plan, use of a cost accounting system, preparation of a valid cost-benefit analysis, consideration of viable alternatives, determination of how the proposed technology benefits would meet the department's business needs, establishment of a dispute resolution process, hiring of a project manager with project management experience, and employing a process to implement proposed changes. Without establishing a strong and effective management structure, the state risks losing control of the project.

8. Require Letter of Credit From Vendors on Larger Projects

Should a project fail, it is beneficial for the state to have a financial instrument from which it can recover some of its losses. Historically, the state has requested a *performance bond*. In order to collect on a performance bond, the state must make a case to the issuer of the bond that the vendor did not meet the terms of the contract. The issuer then pays the bond, or hires another vendor to finish the work. Thus, the issuer of the bond may have a conflict in paying the bond to the state since the issuer loses this money.

Instead, a *letter of credit* can also be issued to protect the state's financial interests. A letter of credit is typically easier to collect than a performance bond because it does not require the state to go to a third party which has a vested interest in not releasing the money.

The letter of credit may add cost to the project since it requires the vendor to make more capital available than does a performance bond. However, on larger projects, the state's risk is larger and a letter of credit increases its ability to recover potential losses.

9. Heed Advice of Quality Assurance Contractor or Explain Why Not

Quality assurance contractors may help departments identify and assess the significance of problems that occur as projects are implemented. These contractors also propose solutions to the identified problems. This secondary vendor assists the department in assessing the prime contractor's performance, thereby minimizing risk by identifying potential problems early in the project's life.

These quality assurance vendors are sometimes known as independent verification and validation (IV&V) vendors. These vendors use a prescribed process to assess the primary contractor's performance by reviewing planning documents, assessing the quality of the system design, evaluating the code being written, and a variety of other tasks. The IV&V vendor makes recommendations to the department on how to obtain a better quality product from the prime contractor.

Departments which hire a quality assurance contractor should follow the advice of the contractor or document why the advice is not being followed. If the IV&V's recommendations are not going to be followed, the return on the investment of hiring the quality assurance contractor is negated. This in turn can mean that the project faces unnecessary risk.

10. Pay Vendor Only Upon Acceptance of Tested Project Deliverables

Historically, the state has paid vendors based on a contractually agreed upon schedule, which did not necessarily coincide with the delivery of a completed component of the project. The result is that vendors received payment whether or not progress had been made on the project. Thus, the state accepted all the financial risk by paying the vendor whether the vendor performed or not.

In order to protect the state's investment, vendors should be paid only upon acceptance of a deliverable, which the state verifies meets the terms of the contract.

Contract Management

11. Write Stronger Contracts to Better Protect the State

When writing IT contracts, the state has historically borrowed language from state contracts for commodities or services acquisitions. These contracts understandably did not contain provisional language addressing traditional IT processes such as invocation of liquidated damages or spelling out of dispute resolution processes. As a result, the state used inadequate contract terms which resulted in the state being in a compromised position when conflicts arose. The state's IT contract language needs to better set out responsibilities, liability, the dispute resolution process, and terms of payment in order to protect the state's interests.

The state should seek assistance from outside experts who have experience writing contracts for IT projects and require the use of this language in IT contracts.

12. Enforce the Terms of Contracts

In the past, departments have not enforced the terms of IT contracts for a variety of reasons. A frequently cited reason is that the department did not want to antagonize the vendor by assessing liquidated damages for failing to meet the agreed upon schedule if there was additional work the contractor was to perform. The result, though, is that the vendor is not held to the terms of the contract, thus rendering the liquidated damages' provision meaningless.

When a vendor knows it will not be held to the terms of the contract, the contract becomes meaningless. The contractor should not receive payment for services not delivered, or delivered outside the agreed upon terms. The state should send a clearer message to vendors that they will be held responsible to meet the terms of contracts.

Conclusion and Recommendations

There is no single reason why IT projects fail, but we believe that employing the 12 best practices outlined above on each IT project will increase the opportunity for success. ❑

The original report was prepared by Mary Winkley of the California Legislative Analyst's Office and is available at their internet site at ***http://www.lao.ca.gov/1298_info_technology_best_practices.html***

Virtually LBO

Budget Season Prompts Database Development

— Barbara Mattei Smith

With the introduction of the transportation budget, the budget season has officially begun. The Legislative Budget Office assists the legislature in the preparation of the state's biennial budget through the preparation of economic forecasts, analyses of each agency's budget request, comparison reports of legislative changes as the budgets are amended, expenditure spreadsheets, and brief recaps of major spending and policy areas. By the time the budget process has been completed, LBO will have printed more than 150 reports containing over 5,000 pages. And, for the first time, each of these documents will be available on the web.

In preparation for the budget process, we have been developing database systems and document templates for both the printed and web documents. We have redesigned and restructured the web site to provide easier access to our reports as they become available. The results of these efforts are beginning to take shape at ***http://www.lbo.state.oh.us/ohbudget/opanalysis/***, the start page for all LBO documents related to the operating budgets of the 2000-2001 biennium. Currently, analysis is available for the transportation budget, the Bureau of Workers' Compensation budget, and the Ohio Industrial Commission budget. Additional documents will be posted as they are published. Be sure to bookmark this site to keep up with the latest budget changes! ❑

Speaking of beginning the budget season here in Ohio...

Before those reports can be posted to our web site, they must first be written and assembled. We will spend much of our time over the next six months compiling data, breaking down and analyzing the state's budget, and drafting amendments and language for the budget bill. In addition to all of the budget-related activity, we will continue to provide fiscal and program analysis on other bills pending before the general assembly. There are only so many hours in the day. How do we do it all, you ask? We can't!

As a result, ***Budget Footnotes*** may not be published on its regular schedule in the months ahead. Once the budget has been passed (June 30, 1999), we will return to our regular publishing schedule.