OFFICE OF BUDGET AND MANAGEMENT
MID BIENNIUM REVIEW
TESTIMONY OF TIMOTHY S. KEEN

BEFORE THE

HOUSE FINANCE COMMITTEE

MAY 3, 2016

Chairman Smith, Ranking Member Driehaus and members of the House Finance Committee, my name is Tim Keen and I am director of the Office of Budget and Management. I appreciate this opportunity to appear before you today to testify in support of Chairman Smith's budget related bill that will come before this committee.

My intention today is to provide a perspective on the Mid–Biennium Review process and to provide a broad overview, with selected examples, of the types of initiatives contained in this proposed bill, which I will refer to as the OBM-MBR. The Administration has worked with the House and Senate leadership to review and discuss the issues addressed in this bill and looks forward to continuing that cooperative relationship as this bill is considered in legislative hearings in the weeks ahead.

The Mid-Biennium Review Process

As you will recall from the first two Mid-Biennium Reviews (MBRs) in 2012 and 2014, development of the MBR is a structured budget and policy process created by Governor

Kasich to continue his agenda of reform without waiting another two years for the next biennial budget process. As with the previous two MBRs the Kasich Administration undertook a comprehensive review of the enacted budget, state policies, programs and agency operations. Cabinet directors again were asked to rigorously review the programs they administer and their internal operations and to make recommendations for improvement. Once again, the Administration reached out to external stakeholders to solicit their input.

This year, unlike previous MBR cycles, the resulting proposals are being introduced as a series of targeted bills as opposed to a single, comprehensive MBR proposal. So far, five bills have been introduced: H.B. 474, the Higher Education MBR, and H.B. 483, the Developmental Disabilities MBR, are both pending in this committee; S.B. 293, the Parks and Natural Resources MBR, is scheduled for a vote in the Senate Government Oversight and Reform Committee; H.B. 512, the Water Quality MBR, is before the House Energy and Natural Resources Committee; and S.B. 319, the MBR to address issues related to opiate abuse, is under review in the Senate Health and Human Services Committee.

The bill before you today, which has been referred to as the 'OBM-MBR', makes a number of changes that can be classified into four broad categories: appropriation changes and adjustments, operating budget and prior MBR provision amendments; capital bill and re-appropriations bill clean up; and tax provisions;

Appropriation Changes and Adjustments

The OBM-MBR contains a number of appropriation changes, a few of which are appropriation increases reflective of changing circumstances since the passage of the operating bill. Others are modifications within the existing appropriation authority.

The largest appropriation change in the bill is $18 million to the **Department of Rehabilitation and Correction** (DRC) to provide security and mental health programming improvements, and for the Treatment Transfer program. This program, which was established in H.B. 64, allows DRC to transfer certain non-violent inmates out of DRC institutions and into specific community facilities if they successfully complete a substance abuse treatment program.

The $18 million in this bill also allows DRC to continue to implement a security plan developed by the department to address critical populations within DRC institutions. This security plan includes the conversion of an existing facility to house Close Security inmates, in order to decrease the density of that population throughout all DRC institutions and reduce incidents of violence. This security plan will also allow DRC to implement long-planned reforms to restrictive housing to provide increased programming, mental health treatment, and "out-of-cell time" to meet new national standards.

DRC was appropriated $6.34 million in H.B. 340 in order to begin implementation of these initiatives in the second half of FY 2016. The $18 million in this bill represents the full annualized cost and continuation of those initiatives.

This bill also includes an additional operating appropriation of approximately $1.4 million for the **Ohio State School for the Blind** (OSB). This appropriation increase will offset the loss of a grant that provides for special education outreach efforts.

An example of an appropriation adjustment is the **Ohio Healthier Buckeye Grant Pilot Program** which was established in H.B. 64 of the 131st General Assembly to provide grants to local healthier buckeye councils and other individuals or organizations with the goal of promoting financial self-sufficiency and reduced reliance on public assistance. The program was funded by a year-end cash transfer of $11.5 million from surplus General Revenue funds, and was appropriated $5 million in FY 2016 and $6.5 million in FY 2017. Given the timing associated with establishing grant criteria and reviewing applications, no grant money has yet been awarded in FY 2016. The language included in this bill transfers the unexpended, unencumbered portion of the $5 million appropriation from FY 2016 to FY 2017 to ensure that all original appropriations will be available over the biennium.

Operating Budget Bill and Prior MBR Provision Amendments

This bill will make minor adjustments and corrections to a number of provisions contained in the main operating budget bill (H.B. 64) and in prior MBR bills.

In H.B. 64, the **Department of Administrative Services** proposed adjusting the exempt pay tables by adding a new step 7 to exempt pay grades 12 through 16 to address longstanding wage compression issues between employees and their managers. This amendment splits the step 7 wage increase in two — step 7 and step 8 — so that in the future each step contains a similar percentage increase as steps 1 through 6 that precede them.

Given the addition of this new step 8, this amendment also phases out the existing “step eight only” in order to move these exempt employees onto the revised grade and step schedule. The existing step 8, established in 2000 as a performance pay opportunity, was not widely used and now includes fewer than 200 employees.

Also, in the main budget bill, OBM adjusted the role the Director of OBM, Superintendent of Insurance, and the Tax Commissioner to provide a determination instead of a recommendation on each Job Retention Tax Credit application. Due to a drafting omission, one reference to “recommendations” was not changed to a “determination.” This item corrects this error and clarifies a reference to the Director of the **Development Services Agency.**

Capital Bill and Re-appropriation Bill Clean Up

The OBM-MBR also includes a number of amendments to the capital and capital reappropriations bills that provide necessary clarification on the use of capital funds or correct technical issues such as the identification of the fiscal agent and the proper name of the capital project.

Tax Provisions

The bill contains two proposals that will make amendments to tax law provisions in the Ohio Revised Code.

First, this bill would remove the authority for counties to enact a utilities service tax.

In 1967 the General Assembly granted counties the authority to enact four permissive taxes: the sales and use, real estate transfer, motor vehicle registration, and utility service taxes. With the exception of the utility service tax, all of these taxes have been widely levied by counties and generate more than $2.2 billion annually for county governments. The county utilities service tax has not been levied in the almost 50 years that it has been in state law.

This bill also creates a property tax exemption for a Convention Facilities Authority-owned arena in a county with a population of more than 1 million, even if that arena is leased to a private enterprise. This amendment is to provide Nationwide Arena with the same tax treatment as similar publically owned facilities in Ohio.

Controlling Board Emergency Purposes Contingency Fund

The last provision I call to your attention proposes to direct $25 million for the FY 2016 GRF ending balance to the Emergency Purposes Contingency Fund. During FY16, the amount of emergency purposes requests -- notably wrongful imprisonment cases -- was greater than expected. These requests have already exceeded the $10 million appropriated for emergency purposes in H.B. 64. While the fund still maintains a balance, given the expected availability of GRF funds at the end of the year, it is prudent to replenish the fund to provide for unbudgeted and unexpected circumstances.

Condition of State Finances for FY 2016 and FY 2017

I will close my testimony by providing and overview of the current condition of the GRF as we approach the end of FY 2016 and discuss several factors which will impact the budget for FY 2017. The fiscal condition of the state is state is strong. Our budget is structurally balanced, with ongoing revenues sufficient to cover on going expenses. We have adequate reserves both in the GRF ending balance and the Budget Stabilization Fund, which has a balance of slightly more than $2 billion.

Based on the economic projections and revenue estimates from last June, the appropriations and program disbursement estimates from the budget, as impacted by subsequent acts of the General Assembly, (most notably S.B. 208 and H.B. 340 adopted late last year) the estimated GRF ending balance for FY 2016 is $469.7 million, which is $296 million above the 0.5 percent statutory target. This additional cushion in the ending balance is a prudent hedge against unforeseen developments on either the revenue or spending side of the budget, and is the result of conservative budgeting advocated by Governor Kasich and adopted by the General Assembly.

So far this fiscal year, the budget has performed as expected, and in some respects, better than expected. Through March, GRF tax revenues were $9.2 million, or 0.1 percent above estimate. GRF revenues in total were $256 million below estimate, but only as a result of Medicaid underspending, which produces a reduction in federal reimbursement grants. On the spending side, the state share of Medicaid is on course to come in several hundred million dollars below estimate. Through March, all other outlays were an additional $12 million below estimate.

But as you know, April is the single most significant month of the year for GRF tax revenues as a result of the income tax filing deadline. While, OBM still does not have final information about April revenues, it is clear that income tax revenues came in well short of the estimate. This shortfall seems to be the result primarily of tax year 2015 tax filing payments, not employer withholding collections. The non-wage income on which such tax payments and refunds are based is notoriously volatile and is the most difficult revenue estimating challenge that OBM faces, year after year. In forecasting income tax revenues for FY 2016 and FY 2017, OBM deliberately used what it thought were conservative projections of taxable non-wage income, but it appears that those projections were not quite conservative enough.

The April shortfall is not an issue for FY 2016. As I have stated, the ending GRF balance has sufficient excess built into it to weather some bad revenue news, especially since Medicaid spending is below estimate and there are likely to be some other areas of spending that finish FY 2016 slightly below estimate.

My purpose in raising the April income tax collections is to remind the committee of the customary analysis and actions that OBM takes at the mid-point of the fiscal biennium. After the close of FY 2016, OBM will revise FY 2017 revenue projections based on actual FY 16 results and the most recent information about the course of the economy, both nationally and in Ohio. The income tax shortfall likely will lead OBM to be somewhat more cautious about FY 2017 than we had been. The fact that economic growth has been somewhat weaker than expected a year ago will also lead to caution in our revisions.

National economic growth has been fairly weak through FY 2016, despite solid gains in employment and some evidence that wage growth is finally improving. The broadest measure of economic activity, real GDP, grew by only 0.5 percent in the first quarter of 2016, and has averaged only 1.3 percent growth over the first three quarters of FY 2016. This is appreciably slower growth than either the 2.6 percent growth assumption stated in my original testimony on HB 64, given in February, or the 2.3 percent growth assumption stated in my testimony to the Conference Committee on HB 64 in June. It is possible that growth will pick up significantly in the second quarter. As a number of analysts have pointed out, GDP has fallen into a pattern in recent years of weak first quarters followed by strong second quarters. Still, it seems unlikely that growth will improve enough to hit 2.3 percent for FY 2016.

You may recall that the budget forecast was built on somewhat faster growth in FY 2017. U.S real GDP was expected to accelerate, per Global Insight's baseline forecast, to 3 percent. Personal income growth was expected to accelerate from 3.9 to 5.1 percent. Indeed, Global Insight's latest baseline forecast still calls for U.S. growth to average close to these rates in FY 2017. But Governor Kasich believes that the weaker than expected growth in FY 2016 should make us cautious about the expected accelerations in FY 2017.

Another reason for caution is that, while forecasting models generally are currently not predicting a recession in the 6 month to 12 month horizon, there is more discussion by analysts of increased recession probabilities in the intermediate period, roughly the next 2 to 3 years.

This June will mark seven years of the economic recovery and expansion, which is well above the postwar average of 58 months. There are a number of risk factors noted by those analysts who are wary of recession in the intermediate term. A continuation of low commodity prices, which historically were helpful to U.S. producers, would further hurt the economies of commodity-dependent countries and depress global demand. It could also keep the U.S. energy sector depressed and reduce equity prices, as we saw in 2015 and earlier this year.

Weaker economies outside the U.S., possibly combined with higher U.S. interest rates, could push up the demand for dollars, strengthen the dollar relative to other currencies, and further reduce U.S. exports. These developments could reduce U.S. capital investment and slow down hiring, which would feed back into reduced consumption. In fact, these risk factors were at work last summer, causing recession probabilities to briefly spike upward, although the labor market remained solid and the risk ultimately receded. Nevertheless, U.S. manufacturing indicators remain very weak, and all of these risk factors could reappear and reduce overall U.S. growth once again.

As the budget calendar moves toward FY 2017 and beyond, the issues outlined above make it all the more necessary to continue our practice of being conservative in both our forecasting and our budgeting practice. Much good work has been has been done by

Governor Kasich and the members of the General Assembly during the last five years to put the state's financial house in order. The Governor regularly comments on how fiscal discipline, restraint and sound budget practices have enabled Ohio to cut taxes and increase our economic competiveness, to increase support for education, services for the mentally ill, drug addicted and developmentally disabled, and to support capital improvements for our state agency, higher education, and school and local government infrastructure. The Governor also observes how business leaders tell both he and John Minor at JOBSOhio how our stable finances and predictable budget and tax climate are a competitive advantage as businesses consider where to locate, expand and grow.

The Governor believes we should continue down this proven trail and avoid actions that would jeopardize our hard won achievements to date. The Governor and I offer these comments and observations as a note of caution to inform the spending and revenue decisions of the General Assembly over the remaining course of this year.

Closing Remarks

I appreciate the opportunity to provide testimony today and thank you for your time and consideration. Mr. Chairman, members of the Committee, at this time, I would be happy to address any questions you may have.

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