Explanation of the proposed reform of Ohio's Local Government Fund

Including the steps used to determine local distributions from the new capacity-driven formula

Governor Kasich's FY18-19 executive budget proposal contains a substantial reform of the state's Local Government Fund (LGF) program. The LGF reform proposal would bring the fund into the 21st century, making changes that address the program's longstanding need for modernization, coherence, and equity. Its key feature is a new "capacity-driven" LGF formula that would take effect in calendar year (CY) 2018. Once the reform is fully phased-in, 20 percent of the LGF would be distributed by the State through the new formula, providing funds directly to county governments, cities, villages, and townships in a much different manner than currently exists. That said, it is important to note that the current formula for allocating LGF monies among the 88 county undivided local government funds (CULGFs) is not changed in any way; each CULGF will continue to receive the same share of the fund that it received in CY 2016 and will receive in CY 2017. Total funding to the CULGFs is modestly reduced but these funds will still receive the vast majority of total LGF deposits, about 80 percent.

The proposed new formula consists of three core elements which are discussed below: total funding; allocation of funds to five classes of subdivisions; and the formula used to distribute monies among the subdivisions that comprise each class.

1. **Funding**. Total LGF funding is the same as current law; the LGF will continue to receive 1.66 percent of state tax revenues. During CY 2018 and 2019, the capacity-driven formula will receive a phased-in share of total LGF deposits, expected to equal 10 percent in CY 2018 and 18 percent in CY 2019. By CY 2020, its share of the LGF is expected to reach the 20 percent maximum. Current revenue forecasts indicate the capacity-driven formula would receive an estimated $38 million in CY 2018 and $69 million in CY 2019.

   Funding for the capacity-driven formula in any given month represents a residual amount: it equals the amount remaining in the LGF after allocations are made during the month for the "supplemental" distributions to townships and small villages, and after the required allocations are made to the 88 county undivided local government funds.[1]

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[1] In calendar year 2018, funding for each CULGF will total 95 percent of the amount distributed to the funds in CY 2017. In CY 2019, each CULGF will receive 90 percent of the amount it received in CY 2017. Furthermore, in no year are the CULGFs to receive less than 80 percent of the total net amount deposited in the state LGF during such year. ("Net amount," which we also refer elsewhere as "net LGF proceeds," is the amount remaining in the state LGF after the "supplemental" distributions are made to townships and small villages.) By CY 2020, the CULGFs will likely receive 80 percent of net LGF proceeds (since such amount will likely be greater than 90 percent of CY 2017 CULGF distributions). Note that, starting in CY 2018, the proposal would no longer provide LGF monies for allocation among municipalities based on their relative municipal income tax collections. These distributions amounted to $10 million in CY 2016, and are proposed to stay very close to that level in CY 2017.

2. **Allocation to subdivision classes.** The total funds provided to the capacity-driven formula are divided among five different classes of subdivisions, based on the following percentages: 47.7 percent to cities; 37.3 percent to county governments; 3.7 percent to villages that levy an income tax; 1.5 percent to villages that do not levy an income tax; and 9.8 percent to townships. These equal the aggregate percentage shares of the CY 2014 county undivided LGF distributions.

3. **Distribution Formula.** The capacity-driven LGF distributions are allocated among local governments based on two factors: the subdivision's share of the total population of the subdivision class; and a capacity adjustment factor. The capacity adjustment factor reflects a "tax capacity" measure designed for the subdivision class, based on the primary source of tax revenue used by the subdivision class for its general fund (see listing below). Tax capacity is a concept that measures the relative tax revenue-raising ability of jurisdictions.[2] To measure tax capacity, it is first necessary to acquire appropriate data and make the computations needed to yield each jurisdiction's tax base.[3] It is then necessary to divide each jurisdiction's tax base by its population to produce its "per capita tax base," a standardized, cross-jurisdictional measurement.

Tax capacity represents the degree by which the subdivision's per capita tax base deviates from the average per capita tax base of the subdivision class. The goal of the capacity-driven LGF formula is to direct more resources to communities with lower capacity, so the formula uses an inverse capacity adjustment: a subdivision's share of the formula is increased according to the degree by which its per capita tax base falls below the statewide average, and vice versa. The capacity adjustment is computed by dividing the statewide average per capita tax base for the subdivision class (the numerator) by the jurisdiction's per capita tax base (the denominator). A jurisdiction with lower-than-average capacity will be assigned a capacity adjustment factor exceeding 1.0; a jurisdiction with higher-than-average capacity will be assigned a capacity adjustment factor under 1.0.

The tax (or taxes) used for each class are as follows:
    a. Counties: 80% sales tax base, 20% property tax base
    b. Cities: 100% municipal income tax base
    c. Villages levying an income tax: 100% municipal income tax base
    d. Villages without an income tax: 100% property tax base
    e. Townships: 100% property tax base

We have described the most critical elements used to produce the capacity-driven distributions. Below is a step-by-step explanation of the capacity-driven formula.

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[2] "Capacity" is *not* a measure of actual revenues being produced, which is a combination of tax rate ("effort") and tax base.
[3] For the proposal, the municipal income tax base is computed by dividing tax revenues by the tax rate; the same type of calculation is performed to yield the county sales tax base. The property tax base requires no such computation: the data is already produced by county auditors and reported annually to the Department of Taxation.

**Steps involved in computing a hypothetical subdivision's distributions
from the capacity-driven LGF formula**

For the following computational steps, we use a hypothetical city with a population of 30,000 and we assume total population across all Ohio cities is 6,600,000. The hypothetical city's per capita municipal income tax base is assumed to be $26,000 and the average for all cities is assumed to be $32,500. Note that the figures in Steps Two through Six are to be computed by each December 31st, to be used in making the distributions during the following calendar year. As with the current LGF, all computations for and distributions from the capacity-driven LGF formula are to be made by the Department of Taxation.

Step One: Identify the total amount to be distributed to each subdivision class. Begin with the month's total LGF deposits, and then subtract (1) the $1 million monthly amount reserved for the supplemental distributions to townships and small villages and (2) the amount allocated to the county undivided LGFs. The remainder - which, by CY 2020, we expect to be 20 percent of net LGF proceeds - is provided to the capacity-driven formula. For this hypothetical exercise, let us assume $5.0 million is provided to the capacity-driven formula during the month. Multiply such amount by the subdivision class percentage share; for cities, it is 47.7 percent. Accordingly, the amount to be allocated among cities during the month from the capacity-driven formula is **$2,385,000** ($5,000,000 x .477).

Step Two: Derive the city's proportionate share of population. Its population share is 0.4545 percent (**0.004545** in decimal format), per the following calculation: 30,000 / 6,600,000 = 0.004545. Population is from the most recent decennial Census.

Step Three: Compute the city's capacity adjustment. This equals the statewide average per capita income tax base across all cities, divided by the city's per capita income tax base. The income tax base figures reflect average annual effective taxable income over a five consecutive-year period, with the last year of such period being the second year preceding the distribution calendar year (e.g., for the CY 2019 distributions, average annual income for the CY 2013-2017 period will be used). The capacity adjustment is computed as follows: $32,500 / $26,000 = **1.2538**.

Step Four: Compute the city's "assigned value." This equals the population share multiplied by the capacity adjustment. The figure is derived as follows: 0.004545 x 1.2538 = **0.005698**

Step Five: Sum all cities' assigned values. Based on Ohio city computations we have performed for the proposal, for this exercise we will use a total assigned value of **1.195**.

Step Six: Derive the city's proportionate share of the total assigned value to yield its "capacity share." The capacity share is produced through the following computation: 0.005698 / 1.195 = **0.004768**. Thus, the city would receive 0.4768 percent of the month's capacity-driven distributions to cities. This percentage share would be used for distributions made throughout the entire calendar year.

Step Seven: Compute the month's distribution to the hypothetical city. The city's distribution for the month is the product of the amount allocated to cities from the capacity-driven formula and the city's capacity share. Its distribution for the month is $11,372, per the following equation: $2,385,000 x 0.004768 = **$11,372**.