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Baseline Forecast of GRF Tax Revenues and Medicaid Service Expenditures for the FY 2024-FY 2025 Biennial Budget

Testimony before the Senate Finance Committee

April 18, 2023

Chair Dolan, Vice Chair Cirino, Ranking Member Sykes, and members of the Senate Finance Committee, I am Wendy Zhan, Director of the Legislative Service Commission (LSC). I am here to testify on LSC's forecasts for General Revenue Fund (GRF) tax revenues and Medicaid service expenditures in fiscal years 2023 through 2025. The forecasts were developed by LSC's Legislative Budget Office (LBO) in late January. These are baseline forecasts, meaning that they are based on the current Revised Code tax structure and current law and administrative policies on Medicaid. These forecasts do not reflect the effects of any proposed tax or Medicaid policy changes in the executive budget. I will briefly summarize our forecasts in my testimony. The accompanying forecast book provides more detailed information on the current state and forecast of the economy and forecasts of GRF tax revenues and Medicaid service expenditures.

The economy

The outlook for state government revenues is greatly influenced by the course of Ohio's economy and the economy of the nation. The U.S. economy has continued to expand since soon after the COVID-19 outbreak, and employment has continued to increase. But during 2021 and 2022 inflation emerged as a growing concern for Federal Reserve policymakers, and the Fed has responded by increasing interest rates rather sharply starting in March 2022, from a near-zero level during the height of the pandemic to a range of 4.75% to 5.0% at the conclusion of its recent meeting. These increases have slowed growth in inflation adjusted gross domestic product, i.e., real GDP, but have shown limited impact as yet on labor markets, as exhibited by the increase in payroll employment of over 1 million reported for the first three months of 2023. The economic forecast on which LBO based our revenue forecast projects a short, relatively mild recession during the first half of calendar year 2023 followed by a steady recovery through the upcoming biennium.

Real GDP is the broadest measure of economic activity. Nationwide, real GDP grew at a healthy pace of 5.9% in 2021, but declined slightly in the first half of 2022. It then resumed growing in the second half of 2022, at a moderate rate: a 3.2% annual rate in the third quarter and a 2.6% rate in the fourth quarter. That brought its growth for all of 2022 to 2.1%. The pattern of Ohio's real GDP growth last year was similar to the national pattern. Ohio's real GDP fell in the first and second quarters, by 1.7% and 1.1%, respectively, and began to recover in the third, but more slowly than the rate nationally. The growth rate was 1.2% in the third quarter and 0.4% in the fourth quarter. For 2022 as a whole, Ohio's real GDP grew 1.5%.

The labor market has continued to recover from dislocations due to the pandemic. Payroll employment for the U.S. as a whole recovered to prepandemic levels in June 2022. In contrast, Ohio payroll employment, at 5.58 million in February, the latest month for which data is available, remains about 36,000 below the level of February 2020, despite growing 849,000 since April of that year. Nevertheless, Ohio employment growth has been steady, if slow, with only five months of month-over-month employment declines since April of 2020. In February, Ohio's total payroll employment rose by 900 to about 77,800 (1.4%) above the year-earlier level. Employment gains were largest over the past year in service industries, particularly industries hard-hit in the pandemic including the leisure and hospitality sector and health care. The unemployment rate in the state, at 3.9% in February, remains higher than in the nation as a whole. Nationwide, the unemployment rate was 3.5% in March, almost its lowest level since 1969.

Inflation as measured by the Consumer Price Index for All Urban Consumers (CPI-U) was 5.0% for the year ending in March. But year-over-year inflation has declined steadily from a peak of over 9% in June. Many analysts focus attention more closely on so-called core inflation, as measured by CPI-U excluding food and energy. Year-over-year growth in that measure was 5.6% in March, down from a recent peak last September.

In developing our revenue forecasts, LBO economists have relied on IHS Markit, a leading economic forecasting firm, for the macro economic forecasts. Specifically, we have used the company's December baseline forecasts for the nation and Ohio as the source for most input or explanatory variables in our models. Those forecasts are for the economic expansion in the nation and Ohio to resume at a moderate pace during the period corresponding to state FY 2024 and FY 2025, following a mild recession in the first two quarters of 2023. As is detailed in the accompanying forecast book, for the upcoming biennium, IHS Markit's December baseline forecast shows national real GDP growing at about a 1.5% annual rate on average, up from 0.8% growth in FY 2023. Ohio's real GDP is also predicted to continue growing during this period, but at a slower average annual rate of about 1.2%. Personal income is forecast to grow during the same period, by about a 4.5% annual rate on average, both for the nation and for Ohio. Personal income is not adjusted for inflation, which is projected to decline from 6.4% during the current fiscal year to 2.7% in FY 2024 and 2.2% in FY 2025, as measured by the consumer price index. The unemployment rate is anticipated to increase due to the predicted recession, from 3.9% in FY 2023 for the nation, to 5.2% on average in FY 2024, before declining to 4.8% in FY 2025. The comparable numbers for Ohio are 4.4% in the current fiscal year, rising to 5.9% in FY 2024, before declining to 5.5% the following year.

A number of factors could alter the economic outlook and the baseline forecasts presented here. Recent data indicate that a recession did not begin in the first quarter, as predicted by IHS Markit in December. Perhaps the overriding current economic question is whether policymakers at the Fed will be able to conduct monetary policy so as to reduce inflation to target levels effectively, without inducing a recession. Various media reports raise this very question, asking whether the Fed will manage a so-called "soft landing" of the economy. In addition, geopolitical risks could affect the economy. These include risks we are aware of, like

Russia's war on Ukraine or frictions between the U.S. and China, and risks that are currently unforeseen.

So, as you consider our tax revenue projections, please remember that economic forecasts are inherently uncertain, just like any other attempt to predict the future. We are confident in our methodology, but we know that the forecast will be wrong in some respects and to some degree. Our baseline forecast could prove too optimistic regarding economic growth in the nation and Ohio. Alternatively, it could be too pessimistic.

Revenue forecasts

As stated earlier, the LBO baseline forecasts for FY 2024 and FY 2025 assume the current Revised Code tax structure. So, for example, the personal income tax forecast reflects the various income tax changes enacted in H.B. 110 of the 134th General Assembly, including the 3.0% reduction in tax rates on nonbusiness income, the reduction in the top marginal rate to 3.99%, and the increase in the threshold below which no tax is owed. Similarly, our baseline forecasts assume the Public Library Fund (PLF) and the Local Government Fund (LGF) would each receive 1.66% of GRF tax receipts during the next biennium, which is the percentage established in the Revised Code. An uncodified provision of H.B. 110 temporarily increases the PLF share of GRF tax receipts to 1.70% during the current biennium.

Table 1. LBO Baseline GRF Tax Revenue Forecasts (After Distributions to the PLF and LGF)

	FY 2023	FY 2024	FY 2025
Total	$28,527.0 million	$29,097.6 million	$30,327.1 million
Dollar Growth	$374.5 million	$570.6 million	$1,229.6 million
Percent Growth	1.3%	2.0%	4.2%

As seen from Table 1, for FY 2023, LBO estimates total GRF tax revenue, after distributions to the two local government funds, to be $28.53 billion, which is an increase of about $375 million, or 1.3%, from FY 2022. The estimated growth rate for FY 2023 as a whole is notably lower than the growth rate for the year to date through March, which is 5.4%. This reflects expectations that revenue received during the income tax filing season will be below estimate due to a decline in capital gains, resulting from stock market weakness last year, and to tax changes enacted late in the 134th General Assembly. Those tax changes are discussed in more detail in the accompanying forecast book.

For FY 2024, LBO forecasts total GRF tax revenue to be $29.10 billion, an increase of about $571 million, or 2.0%, from FY 2023. Major GRF taxes are generally forecast to grow at a moderate rate during the year, in spite of lingering effects of the mild recession forecast by IHS Markit. There is a projected small increase of 0.5% in total sales and use tax revenue in FY 2024, due to the effects of the recession on retail sales and to a gradual decline in inflation that reduces growth in prices of taxable goods and services. In addition, prices of motor vehicles are predicted to decline during FY 2024, following the substantial increase in average prices during FY 2022 and FY 2023 year to date, resulting in a slight decline in the forecast for auto sales tax revenue. Income tax revenue is forecast to increase 4.4% in FY 2024. The commercial activity tax is forecast to grow by 2.7% in the same fiscal year.

For FY 2025, LBO forecasts total GRF tax revenue to be $30.33 billion, an increase of $1.23 billion, or 4.2%, from FY 2024. Revenue from the total sales and use tax is expected to increase 3.0% in FY 2025. The personal income tax is forecast to grow by 6.6%, and the commercial activity tax is forecast to increase by 5.2%. The forecasts of these major taxes reflect the effects of the predicted economic expansion and the accompanying growth in Ohioans' incomes.

Comparison of LBO and executive baseline tax revenue forecasts

Compared with the executive's baseline GRF tax revenue forecast, LBO's forecast is higher for the current fiscal year and for FY 2024, but lower for FY 2025. The differences between the two forecasts are summarized in Table 2. The differences are presented as LBO's forecast minus the executive's forecast, so the positive numbers indicate a higher LBO forecast and the negative numbers indicate a lower LBO forecast.

Table 2. Summary of LBO and Executive Baseline GRF Tax Revenue Forecast Differences

	FY 2023	FY 2024	FY 2025
Dollar Difference	$151.3 million	$156.0 million	-$48.3 million
Percent Difference	0.5%	0.5%	-0.2%

The differences between the two forecasts are relatively small. For the current fiscal year, the difference amounts to $151 million or 0.5%. For the next biennium, the overall difference is under $108 million or 0.2%. As stated earlier, LBO economists forecast total GRF tax revenue to increase by 2.0% in FY 2024 and 4.2% in FY 2025, in comparison with a growth rate of 2.0% in FY 2024 and 5.0% in FY 2025 under the executive baseline forecast. However, the executive forecast started with a somewhat lower FY 2023 base. Essentially, compared with the executive forecast, LBO economists anticipate slightly higher revenue growth during the last five months of the current fiscal year, but a slightly slower acceleration of growth in FY 2025.

Medicaid service expenditure forecast

Medicaid services are an entitlement for individuals who meet eligibility requirements. This means that if eligible for Medicaid, the individual is guaranteed the benefits and the state is obligated to pay for them. Medicaid expenditures also comprise a significant portion of the state GRF budget. It is for these two reasons that both LBO and the executive forecast Medicaid caseload and expenditures.

Medicaid caseload is driven by a number of factors. The impact of the COVID-19 pandemic has played a major role on the caseloads since March 2020. The federal government recently granted states approval to restart eligibility redeterminations and associated disenrollments.

Ohio resumed its routine eligibility operations on February 1, 2023. This will cause those who are no longer eligible for Medicaid to be disenrolled from the program. Particulars of this unwinding process could have a material impact on the caseload and expenditure forecasts presented here.

When LBO economists developed this forecast in late January, they expected the total number of persons enrolled in Ohio Medicaid to decrease 0.47%, from an estimated 3.46 million in FY 2023 to 3.45 million in FY 2024, and decrease another 0.83% to 3.42 million in FY 2025.

For FY 2024, LBO's baseline forecast for Medicaid service expenditures, excluding administrative expenditures, is $38.16 billion in combined state and federal dollars. This is a $2.15 billion or 6.0% increase from estimated service expenditures of $36.01 billion for FY 2023. For FY 2025, combined state and federal Medicaid service expenditures are projected to be $40.17 billion, a $2.01 billion or 5.3% increase from FY 2024.

Compared with the baseline forecasts presented by the executive, LBO's baseline forecasts for Medicaid service expenditures are somewhat higher in the current fiscal year but lower in each fiscal year of the next biennium. The differences between the two forecasts are summarized in Table 3. The differences are presented as LBO's forecast minus the executive's forecasts, so the negative numbers indicate a lower LBO forecast and the positive numbers indicate a higher LBO forecast.

Table 3. Summary of LBO and Executive Baseline Medicaid Service Expenditure Forecast Differences

	FY 2023	FY 2024	FY 2025
Dollar Difference	$81.9 million	-$405.2 million	-$106.5 million
State Share	*$20.0 million*	*-$111.8 million*	*-$30.4 million*
Percent Difference	0.29%	-1.35%	-0.34%

For the current fiscal year, the difference amounts to almost $82 million or 0.3% in combined federal and state expenditures. The difference in the state share of those expenditures is $20 million. For the next biennium, in dollar terms, the difference is about $512 million in total expenditures and $142 million in the state share of those expenditures. In percentage terms, the total forecast difference is less than one percent (0.8%) over the biennium. About 79% of the difference in the biennial forecast is in FY 2024. The differences between the two forecasts are largely influenced by somewhat different caseload forecasts resulting from certain different assumptions and from different forecast models.

Chair Dolan and members of the Committee, thank you for the opportunity to present the LSC forecasts. The staff and I would be happy to answer any questions that you may have.