UPDATE ON REVENUE PROCESS AND THE LEGISLATIVE FINANCE COMMITTEE

A Report Prepared for the

Legislative Finance Committee

By

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REVENUE PROCESS UPDATE

The Steering Committee on the Revenue Process met January 30, 2012 with recommendations for all three committees (Legislative Finance Committee (LFC), Legislative Council, and Revenue and Transportation Interim Committee). Jeff Martin created the following document to update the committees regarding the revenue estimating process review: http://leg.mt.gov/content/Committees/Interim/2011-2012/Revenue-and-Transportation/Meeting-Documents/REVENUE_EST_PROCESS_2401JFQA.pdf. In addition, Terry Johnson created the following document to follow up on issues that the Revenue and Transportation Interim Committee was asked to consider: http://www.leg.mt.gov/content/Publications/fiscal/rev_transp/REP-combined.pdf.

The Steering Committee asked the LFC to consider two areas:

1. How should the Montana legislature address inherent volatility in revenues?
2. Should the legislature hire a professional organization to evaluate the revenue estimating models used in Montana?

MANAGING VOLATILITY

Revenue volatility was one of the tools suggested in the Pew Research paper: "*Cracks in the Crystal Ball*"
http://www.pewcenteronthestates.org/uploadedFiles/States_Revenue_Estimating_final.pdf

Three tools mentioned in the Pew Research include:

- Building rainy day funds: page 33
- Implementing fiscal devices for limiting reliance on volatile taxes: page 34
- Setting spending rules: page 34

The small group that met on Managing Volatility on December 7th had one recommendation, but did not have an opportunity to consider the other options:

Building rainy day funds: page 33

"One way states can manage volatility during hard economic times is to have enough cash on hand to compensate for estimating mistakes. A few years ago, states were in pretty good shape in this regard. According to NASBO, year-end balances peaked in fiscal year 2006 when states had $69 billion, or 11.5 percent of general fund expenditures, in reserve."

Recommendation from December 7th:

	Action	Proposed Committee	Comments
1.	EFB or Rainy Day fund .	LFC	LFC could consider the overall policy of what level of ending fund balance is appropriate and other means of managing volatility for appropriate fiscal management. Need to differentiate from a "surplus"

Definitions

The group in December discussed how an ending fund balance could act as a rainy day fund, if it were clear that the ending fund balance has a purpose, and is not all "surplus". Specifically, what level of the ending fund balance can be defined as "surplus" and what amount is for absorbing fluctuations in revenue and spending? Staff has drafted the following definitions to help define terms that are used in budgeting to aid in this discussion.

Montana Definitions –Montana specific definitions as developed by LFD staff

The following Montana specific definitions were developed after considering definitions acquired from various government budgeting websites.

Deficit is the difference between total current revenues including "ending fund balance" and current appropriations when the result is negative.

Structural balance is the difference between ongoing revenue (does not include any fund balance) and ongoing spending over a specific time frame.

Budget gap is the difference between the forecast revenues and the forecasted cost of current government services over a specific time frame. This analysis would include one-time revenues, present law spending, or surplus ending fund balance, if these items are known.

Ending general fund balance is the beginning fund balance + revenues – expenditures over a specific period of time.

Required ending general fund balance is 1% of all general fund appropriations in the biennium. Any level less than this would require the executive to impose budget reductions per MCA 17-7-140.

The LFD will use the above definitions when describing fiscal status of the state.

Decisions for the LFC

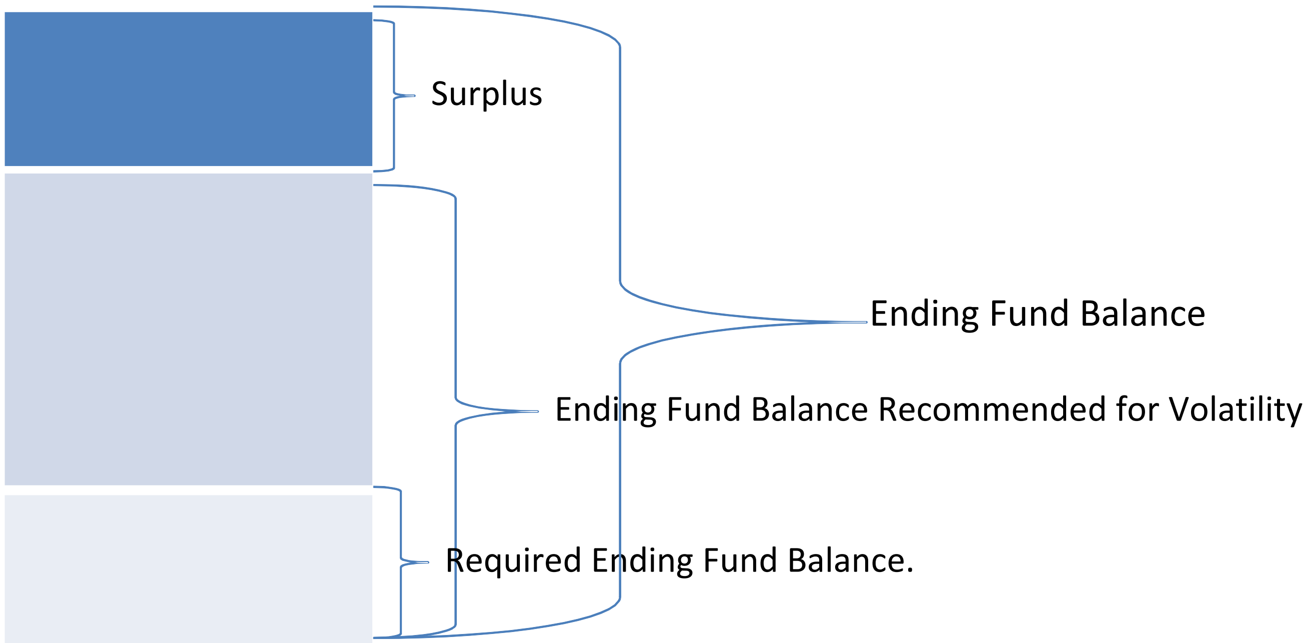
The following definitions require LFC policy decisions to determine the best approach for the legislature. No specific definition is being requested at the March meeting.

Ending fund balance recommended for volatility (a more descriptive title may be developed) is an amount recommended to account for volatility in the ending fund balance. This amount would be above the "required ending fund balance" to offset fluctuations in revenues and spending to fund the authorized level of government services over the biennium. To be determined by the LFC or the legislature, see note below.[1]

Surplus general fund is the anticipated amount of "ending fund balance" that exceeds the "ending fund balance recommended for volatility".

If the Legislative Finance Committee (LFC) adopted definitions for "ending fund balance recommended for volatility" and "surplus general fund", the staff would use these definitions throughout its publications. This stricter use of language could aid the legislature in describing the financial circumstances and better enable the use of the ending fund balance as a tool for managing volatility. The following graphic illustrates the concept:

[1] Staff has not had an opportunity to fully analyze what level of ending fund balance should be recommended. Several analyses are being considered and could be presented to the June LFC meeting.



- Does the LFC wish to research possible definitions for "ending fund balance recommended for volatility" and "surplus general fund" for presentation at a future LFC meeting?

Rainy Day Fund

The LFC could go beyond establishing the new definitions and develop legislation to create a rainy day fund. The following are possible starting points for that endeavor:

Options:

Bills that have been introduced in previous sessions include:

A. The development of a rainy day fund SB 114 (2009): http://data.opi.mt.gov/bills/2009/billpdf/SB0114.pdf
B. HB 645 (2011) on budget stabilization account http://data.opi.mt.gov/bills/2011/billpdf/HB0645.pdf
C. SB 137 (2007) to create budget stabilization account: http://data.opi.mt.gov/bills/2007/billpdf/SB0137.pdf

In addition, the National Conference of State Legislatures (NCSL) has material on its website as follows: http://www.ncsl.org/issues-research/budget/state-budget-stabilization-funds-spring-2008.aspx

- Does the LFC wish to pursue rainy day fund legislation?

Other Methods of Managing Volatility

The following are the other two tools addressed in the Pew Research Paper "*Cracking the Crystal Ball*".

Implementing fiscal devices for limiting reliance on volatile taxes: page 34

"Policy changes to a budgeting system can be a great help sometimes. Massachusetts, for example, addressed part of its volatility problem by making changes in the way revenues from the capital gains tax can be used. Capital gains are one of the most topsy-turvy revenue sources for states because they track the ups and downs of the stock market. Massachusetts relied heavily on capital gains-related revenues in its 2008 budget, to the tune of $2.1 billion. But the following year, capital gains brought in only $500 million, leaving a huge hole in the budget. The same phenomenon occurred in 2001 following the dot-com stock boom and bust."

Setting spending rules: page 34

"Some states have rules in place that prevent them from spending all the revenues they expect to collect in a given year. That way, if revenues come in lower than anticipated, the fiscal consequences are not as severe."

- Does the LFC wish to pursue other forms of managing volatility?

EVALUATION OF LEGISLATIVE REVENUE ESTIMATING MODELS

The Legislature could hire a professional econometric firm to evaluate the models used to calculate the primary revenue estimates. The estimated cost of this analysis is between $20,000 and $30,000 and could be performed in approximately two to three months.

- Does the LFC wish to pursue improved accuracy through hiring a professional econometric firm to evaluate the models used to calculate the primary revenue estimates?