LFD GENERAL FUND
PRELIMINARY BUDGET OUTLOOK
"BIG PICTURE REPORT"
2011 BIENNIUM

A Report Prepared for the

60th Legislature

By

Legislative Fiscal Division

October 7, 2008

Legislative Fiscal Division

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INTRODUCTION

PURPOSE

The purpose of this report is to provide the Legislative Finance Committee (LFC) and the members of the legislature with a preliminary projection of the general fund balance for the 2011 biennium at present law levels of revenue and expenditure. The projection estimates the availability of funding for maintenance of existing services as well as for new and expanded programs. This report is intended to provide a broad overview of the scope of present law fiscal issues the legislature may face in the 2009 session, and the starting point, or benchmark, for crafting the 2011 biennium budget priorities. These projections are based on "broad brush" general assumptions of expenditure and revenue patterns from the most current available information, and will be refined as staff undertakes detailed budget analysis and revenue estimation in preparation for the 2009 legislative session.

The assumptions used in making the projections and the adjustments made to derive present law are discussed in the body and appendix of the report.

EFFECTS OF ACUTE ECONOMIC UNCERTAINTY

Unlike past biennia, the current level of economic uncertainty that is prevalent in both the national and world economies is unsurpassed. The housing market meltdown and the financial markets crisis, combined with “out of sight” energy prices has created a highly volatile and unpredictable economic pattern. As staff has exercised due diligence in preparing this report, the shifting sands of economic conditions has created an uncomfortable position of issuing a report that is based on current data that is immediately dated because it uses assumptions that do not necessarily reflect the emergent economic crisis. For example, the revenue and disbursement estimates contained in this report are based on national and state economic forecasts prepared by Global Insights in July and August. Obviously, these forecasts did not anticipate or include the recent phase of the financial market crisis. As Global Insight stated in a bulletin alert issued October 6, “the worst fear was that the financial crisis and the slowdown in economic growth would reinforce each other, dragging the economy into a recession, perhaps a severe one.” Even this national economic forecasting firm is unsure what may be forthcoming in terms of future economic conditions.

This report has been prepared with the most current information available. It should be noted that as staff prepare for the 2009 legislative session, economic conditions will likely vary widely from where we are today. The probability that the numbers portrayed in this report will change negatively as we proceed with our budget analysis is extremely high. Because of this conundrum, an amount has been included in the report as a “placeholder” for the potential impacts of this expected downturn. It represents an estimate of the amount of the projected balance that could “evaporate” if there is a significant downturn in the Montana economy and resulting decline in state revenue collections. To determine this amount, the downturn in revenue collections experienced during the 2002-2003 fiscal period was used as a proxy for the potential impacts.

For an explanation of assumptions used to develop the revenue trends for the report, the sensitivity of Montana’s revenue stream to world events and investment opportunities, and the potential inaccuracies in the estimates if the impacts of this crisis are mistimed and miscalculated, see the discussion “Economic Uncertainty and Revenue Trends” beginning on Page 10.

SCOPE OF REPORT

As described above, this report focuses on the projected present law fund balance in the general fund. In addition to the projection, it includes: 1) a discussion of the assumptions used to derive the present law projections; 2) a summary of the adjustments made to derive present law; 3) recommended LFD adjustments; 4) significant issues not included in the projections due to an uncertain or unknown impact; and 5) a discussion of the structural balance in the general fund account.

Present law levels represent the amount necessary to continue programs and services authorized by the previous legislature, and include caseload and workload increases, and enrollment adjustments. Statute requires that the executive submit a present law budget to the legislature and that the Legislative Fiscal Analyst (LFA) provide an analysis of present law.

The projections do not include other fiscal issues that may face the 2009 Legislature, including executive or legislative new proposals/initiatives, other potential FY 2009 supplemental appropriations, pending litigation cases, or the potential impact of voter initiatives. These and other issues are listed in Table 2 and are discussed beginning on page 11 of this report.

"MODEL" APPROACH

The projections in this report estimate revenues and expenditures of state government for nearly three full years into the future. Even though the methodology used is based on a statutorily defined budget process, there is still room for debate as to the details of those calculations, and the assumptions used in making the projections. Further, the projections are made within a volatile, dynamic environment, not the least of which is the unpredictable nature of economic forecasting, which is subject to political, demographic, and other impacts. As such, the acceptability of the projections is going to be subject to the unique political and other perspectives of the reader.

In an attempt to make the projections as useful as possible to a diverse audience, the analysis is presented in a 3-step approach, as reflected in the table on page 3.

Table 1 – Statutory Present Law and Reserves

The first tier of data in Table 1 reflects those projected disbursements that fit neatly into the statutorily prescribed definition of present law. Caution is encouraged, however, in relying solely on those projected disbursements in assessing the factors the legislature needs to take into consideration in adopting a balanced budget for the 2011 biennium. Factoring in a reserve for an ending fund balance and such known issues as fire and other emergency costs is critical to good fiscal policy, and as such, a second tier consisting of recommended estimates for such allowances are also provided in Table 1, largely based on historical actions by the legislature and on sound fiscal practice. They are, however, subject to less clarity than the disbursement estimates in Table 1, and the distinction is made on these more "policy oriented" issues so that the reader can draw a separate and distinct conclusion about the merits of these estimates. In general, however, the projected fund balance after taking into consideration LFD recommended adjustments is likely to be a more realistic projection of the level of funds available after funding present law and adequate reserves.

In addition to the reserves discussed above, Table 1 includes a reserve for the volatile economic outlook discussed on Page 1. This represents a broad-brush estimate of the decline in fund balance if there is a significant downturn in Montana's economy. The legislature should not rely on the availability of these revenues pending the outcome of the current economic upheaval.

Table 1 also addresses the issue of structural balance, identifying the amount of the excess that can be spent without creating structural imbalance.

Table 2 – Potential Impacts Not Included

A third tier of information is provided in Table 2 for those issues with potential impacts on the 2011 biennium budget for which the budget impact is either highly uncertain or unknown, depending on subsequent economic or other events. A prime example is I-155, the Healthy Montana Kids initiative. Inclusion of this or any of the other issues in Table 2 in the projections would be highly speculative at this point, but clearly they need to be considered in any assessment of the budget picture for the 2011 biennium, and in legislative deliberations to balance the budget.

It is strongly recommended that all three levels of information be taken into consideration in developing conclusions about the budget projections for the 2011 biennium. By presenting it in this tiered fashion, it allows the reader to use the presentation as a model, and to "pick and choose" their estimates for the items in arriving at their own perspective of the status of the 2011 biennium budget outlook.

2011 BIENNIUM BUDGET PROJECTION

PROJECTED GENERAL FUND BALANCE

Present Law

The projected present law ending general fund balance for the 2011 biennium is $778.6 million (Table 1) when using the most reliable available data and allowing for a 3.0 percent ending fund balance reserve, a reserve for wildfire suppression costs, and a reserve for expenditures from the emergency appropriation. However, caution is urged in light of the potential of a significant economic downturn that is not fully captured in this projection. If a reserve of $275 million is included for the potential effects of a more severe economic downturn, the projected present law ending fund balance is $503.1 million. Until the severity of the economic crisis can be more reliably projected, staff recommends inclusion of this reserve using the smaller $503.1 million when estimating funds available for policy decisions on prioritization of present law expenditures, new initiatives, tax reform, and an appropriate general fund reserve.

2011 Biennium General Fund Outlook
In Millions
Table 1

Beginning Fund Balance (Before Supplementals)		**$483.309**
Anticipated Revenue		**$4,217.137**
Disbursements		
Fiscal 2009 Supplementals		-
Fiscal 2008 Base times 2 (Excl. stat. approps.)		3,018.598
Present Law Adjustments		366.550
Public Schools	78.209	
Public Health	116.545	
Corrections	68.872	
Higher Education	43.007	
Judiciary	5.928	
All Other Agencies	16.883	
Other Adjustments	37.106	
Fiscal 2008 Base times 2 (Stat. approps. + trnf.)		350.090
Present Law Statutory Appropriations		5.566
Present Law Transfers		0.491
Feed Bill and Reversions		2.028
Total Disbursements		**$3,743.323**
LFD Recommended Reserves		
3.0 % Fund Balance Reserve	126.514	
Wildfire Suppression Cost Reserve	35.494	
Emergency Appropriation Reserve	16.500	178.508
Projected Present Law Excess		**$778.615**
Economic Uncertainty		(275.479)
Excess With Economic Uncertainty		**$503.136**
Projected Present Law Excess Components		
Revenue Less Disbursements		**$421.820**
Remaining Balance		**$356.795**

Table 2

Other Significant Issues Not Addressed Above
Other Potential 2009 Biennium Cost Over-runs (Supplementals)
2011 Biennium Pay Plan
Litigation Issues
K-12 Funding Adequacy
State Fund Lawsuit
Protested Property Taxes
PPL Montana, LLC River Bed Fees
Long-Range Building Program Deficit
Condition of State Pension Funds
State Fund "Old Fund" Liability
Ballot Initiative - I155 Healthy Montana Kids
Federal Funds
Inflation/Energy Prices
New Proposals and Other Initiatives
Tax Relief/ Rebate Measures
Interest Earnings

As discussed in the previous section, Table 1 represents those projections that fit the statutorily prescribed definition of present law, as well as an estimate of an adequate fund balance reserve, allowances for fire and emergency costs, and for the effects of an anticipated economic downturn. Factoring in an allowance for these issues is sound fiscal policy, and since they generally represent policy oriented issues of the legislature as to the amount of the allowance, they are singled out individually and are presented as LFD recommendations in arriving at a more realistic projection of the level of funds available after funding present law and adequate reserves. These recommendations are discussed in more detail beginning on page 8. Note that the 3 percent fund balance reserve recommended here is a minimum reserve. One option for addressing an economic uncertainty set-aside is to increase the planned ending fund balance reserve.

The projections do not include allowances for other potential fiscal issues with an uncertain or unknown impact (Table 2). Although not included, the reader should be aware of these potential impacts and factor them in to their assessment and conclusions about the general fund outlook for the 2011 biennium. Each of the issues in Table 2 are discussed beginning on page 11.

While Table 1 shows a significant present law excess after reserves, it is important to consider the issue of structural balance of the general fund before concluding whether the entire excess can be used for state services and tax policy initiatives of an ongoing nature. For the 2011 biennium, anticipated revenues exceed present law disbursements by $421.8 million (Table 1). Therefore, $421.8 million of the projected excess could be used for ongoing state services growth or tax policy initiatives without creating a structural imbalance, at least in the 2011 biennium. If the estimates are adjusted to accommodate a reserve for a potential economic downturn, the amount of the projected excess that could be used for ongoing state services/tax policy without creating a structural imbalance is $146.8 million. The remaining $356.8 million should only be used for one-time initiatives if a structural balance is to be maintained. For a further discussion of this issue, see the discussion of "Structural Balance" on page 15.

BUDGET SURPLUS VERSUS ECONOMIC DOLDRUMS

The projected present law excess provides a stark contrast from the $230 million negative balance the 2003 Legislature originally faced in crafting a budget for the 2005 biennium, which left insufficient funds to even continue existing programs and services at current levels. And while the projected excess is quite similar to the record surplus balance inherited by the 2007 Legislature when developing the 2009 biennium budget, the economic outlook is significantly different. In fact, the economic outlook and resultant state revenue forecast could be similar to the conditions inherited by the 2003 Legislature. However, in 2003 there was no "surplus" to mitigate the effect of the economic downturn, and deep reductions in state programs/program growth were required. In contrast, while the economic outlook facing the 2009 Legislature is potentially worse, there is a significant budget balance to mitigate the impacts of the expected downturn, at least for the 2011 biennium.

The primary factor that has contributed to this stronger budget picture is a strong state economy over the past several years and a significantly stronger than anticipated growth in actual and projected general fund revenue collections (primarily individual, corporate and oil and gas production taxes). Montana is among an elite few states in this "surplus" status going into the anticipated economic downturn. As reported by the National Conference of State Legislatures (NCSL), the majority of states have not enjoyed the strong state collections in recent years, attributable primarily to the sluggish economies of industrial states and lags particularly in corporate tax and sales tax revenues. As an example, California enters this economic crisis with a multi-billion dollar deficit, and Michigan and Ohio are also in a significant deficit fund balance position. It has been states rich in natural resources and agriculture like Montana that have seen strong commodity prices that have enjoyed strong state revenue collections and a resultant "surplus" in the face of a looming economic downturn. Thus, Montana has the financial resources to support a present law budget through the 2011 biennium even in the event of a dramatic economic downturn. But it should be kept in mind when crafting a budget for the 2011 biennium that the length of a potential economic downturn could be significantly longer than one biennium, and the ability to sustain a prolonged economic recession should be considered when making budget decisions on the disposition of the present law excess. Establishing a "rainy day fund" would provide a tool for setting aside funds for budget sustainability over the longer term.

ADJUSTMENTS APPLIED TO DERIVE PRESENT LAW

This section discusses the specific monetary adjustments that were made in deriving a present law projection. For a discussion of the underlying assumptions used in arriving at these adjustments, i.e., the concept of present law and the assumptions used to establish a framework for revenue and expenditure adjustments, see Appendix A in the back of this report.

Table 1 includes those projections that fit neatly into the statutorily prescribed definition of present law. The table shows the anticipated revenues and a breakdown of the expenditure adjustments to the base budget to arrive at a present law budget. The major factors causing the changes in revenues and expenditures as shown in Table 1 are discussed below.

Revenues

General fund revenues of $3.945 billion for the 2009 biennium are anticipated to increase by $271.7 million to $4.217 billion for the 2011 biennium, a growth rate of approximately 3.4 percent per year. Individual income, corporation income, and oil and natural gas production taxes are the three sources critical in determining the fiscal status for the 2011 biennium.

Individual income tax is expected to increase by about 8.4 percent during the 2011 biennium, while corporation income taxes are expected to increase by almost 4.4 percent. Growth in individual income taxes is consistent with the anticipated growth in Montana wage and salary income. Corporation income taxes in FY 2009 are expected to decline from FY 2008 levels and then grow moderately in FY 2010 and 2011.

The oil and gas industry in Montana has been undergoing major changes. Improved techniques have allowed new fields to be developed and old fields to be more productive. Increased production combined with higher prices has resulted in an improved revenue picture. Oil and gas production revenues are expected to be $747.4 million in the 2011 biennium, which is up dramatically from the 2005 biennium revenues of $230.4 million. This projection reflects recent high oil prices with the expectation that oil prices will moderate during the 2011 biennium.

On January 1, 2009, new reappraised values for class 4 property – residential and commercial property – and agricultural land and forest land will take effect. The Department of Revenue has been collecting data on the new reappraised values and should publish these values sometime in November, 2008. A preliminary estimate of these values has been incorporated into the revenue estimates for property tax in this report.

Under Montana law, all property subject to cyclical reappraisal is reappraised every six years with the new values phased in over six years, unless the values decline in which case the new value is recognized in the first year (15-7-11, MCA). The last reappraisal took effect on January 1, 2003.

For the upcoming reappraisal, residential property is estimated to increase an average of 30 percent, commercial property 26 percent. In the reappraisal that took place on January 1, 2003, residential property increased on average by nearly 22 percent and commercial property by 18 percent.

Agricultural land and forest land are valued on a productivity basis. This means that the land is valued by discounting the net income it is expected to generate in the future. The net income is derived by assigning each type of land a yield profile times an historical price for the commodities grown on the type of land concerned. It is expected that neither agricultural land nor timberland has changed in value between 2003 and 2009.

The mitigation of reappraisal that was made law in the 2003 legislative session – phasing up of the homestead and comstead exemptions and phasing down of the tax rates for residential and commercial property, agricultural land and forest land – expire at the conclusion of the current reappraisal cycle on December 31, 2008.

Interest rates are expected to retract from the previous high levels. In the general fund, treasury cash account interest is expected to decline from $34.0 million in FY 2007 to $18.5 million in FY 2009. This decrease is anticipated as the average invested cash balance declines as well as short-term interest rates.

It must be emphasized that the estimates in this report are based on the premise that the unusual high revenue growth in the past five years has peaked and will abate in subsequent years. This conservative approach is appropriate to minimize the downside risks associated with revenue estimates that are relying on dated data, and recognizing that more current data will be available in a few weeks that could significantly change the outlook, particularly in view of the current economic crisis.

Expenditures

The projections for the 2011 biennium show that the costs of present law budget would be a base budget of about $3.3 billion plus adjustments of $374 million, for total present law disbursements of $3.7 billion. The major factors causing the $374 million in adjustments are summarized below.

2009 Biennium Known Supplemental Appropriations

No known supplemental appropriations are anticipated at this time, which is a virtually unprecedented situation at this point in the biennial cycle. The lack of supplementals anticipated is due to several factors:

1) Costs of Medicaid were lower than anticipated, as was growth in correctional populations
2) K-12 schools are within funding authorized by the 2007 Legislature for the reasons discussed below
3) The legislature, in special session in September 2007, funded all FY 2008 wildfire costs, and established an appropriation to fund anticipated FY 2009 costs, which were well below the appropriated amount

Certain areas of concern still exist, and are discussed starting on page 11.

Public Schools

There are three significant factors underlying the estimates of cost for the distribution to K-12 in the 2011 biennium: 1) continuing decline in the number of students, 2) inflation of the basic and per-ANB entitlements, and 3) slightly more revenues in the guarantee account that pays for Base Aid.

Enrollments as measured by Average Number Belonging (ANB) in K-12 in 2010 are estimated to decline 0.9 percent in 2010 and 0.5 percent in 2011. This estimate assumes that no more children will be enrolled in full time kindergarten than were enrolled in FY 2009. To the extent that more or less kindergarteners actually enroll, the estimates for ANB in the 2011 biennium will change.

Statute allows for the present law basic and per ANB entitlements amounts to be adjusted by the Consumer Price Index or three percent, whichever is lower. The CPI is estimated to grow at a rate above 3 percent in each year of the 2011 biennium (based on a 3-year average looking back at the past 3 years). Therefore, the basic and per-ANB entitlements were adjusted upward by 3 percent in each year of the 2011 biennium.

Base aid for schools is paid for out of the general fund and the guarantee account. When guarantee account revenues increase, less general fund is required to pay for base aid. The estimate of guarantee account revenues is slightly above revenues received in FY 2009, resulting in a small reduction in general fund needed for base aid.

Public Health

There are four primary adjustments that result in the increase in public health costs:

- $59.6 million for growth in Medicaid service costs, including utilization increases, eligibility increases, and provider rate increases implemented in FY 2009
- $19.3 million due to an increase in the state Medicaid match rate because the Montana economy is performing better relative to the national economy
- $12.9 million for changes in non Medicaid services such as foster care and child care
- $4.0 million in state institution overtime, holiday, and shift differential pay as well as operating cost increases

Medicaid estimates are based on historic cost trends for major services with some adjustments. For instance, pharmacy costs are estimated to increase by 10.0 percent annually, while inpatient hospital costs grow at a 6.4 annual rate. Overall Medicaid service and utilization costs, including FY 2009 provider rate increases, grow about 4.3 percent, excluding the effect of the state match rate change.

Congress is considering economic stimulus legislation that might lower the Montana Medicaid match rate by 1 percent. That change would reduce general fund outlays by $7.0 to $7.5 million per year.

Corrections

The anticipated 2011 biennium present law budget for the Department of Corrections is driven primarily by annualization of programs that will be implemented in the 2009 biennium and projected increases in the number of offenders under the supervision of the department. The estimates utilized in this projection anticipate an annual increase in total average daily population (ADP) of offenders of about 5 percent per year, with increases in individual categories of incarceration/services varying from 4 percent (male secure care, probation and parole) to

12 percent (community alternatives to prison). Additionally, the requirement that license plates be reissued beginning in January 2010 increases anticipated 2011 biennium costs by $4.3 million.

Higher Education

Other Present law cost adjustments for the Montana University System (MUS) funded by general fund include elimination of several one-time-only appropriations included in the general appropriations act for the 2009 biennium, filling the pipeline for the educator loan forgiveness program that was approved by the 2007 Legislature (approximately $1 million), increased operations and maintenance for new space expected to be brought on line in the 2011 biennium (approximately $2.2 million), and faculty termination and promotion costs (approximately $5.8 million) projected for the 2011 biennium. Faculty termination and promotions costs were funded in the College Affordability Plan (CAP) approved by the 2007 Legislature. All adjustments were funded at 81.9 percent general fund, which is consistent with 2007 legislative action.

Student enrollment in the Montana University System was not used by the executive or legislature as a basis for setting the expenditure side of the budget for the 2009 biennium. Consequently, MUS budget adjustments reflecting enrollment shifts are not calculated for the 2011 biennium. Student enrollment for the community colleges <u>was</u> used by the legislature as a basis for setting the expenditure side of the budget for the 2009 biennium. Enrollment projections for the 2011 biennium from the community colleges show a slight decline from FY 2009.

All Other Agencies

This category includes $16.8 million for present law adjustments in agencies of state government not included in other categories. This includes the natural resource agencies and the "administrative" agencies of state government, including the Departments of Administration, Revenue, and Justice.

Other Adjustments

"Other Adjustments" ($37.1 million) consist of various changes made to the FY 2008 base, including the costs of the 2009 biennium pay plan in the 2011 biennium (see below), inflation, and fixed costs. Some of the more significant adjustments are explained below. The vacancy savings rate was maintained at the 2009 biennium HB 2 level of 4 percent for all positions (with limited exceptions). Annualization of any phased-in or phased-out programs, adjustment of biennial appropriations, elimination of all one-time-only appropriations, and full-funding of FTE upon which personal services funding was based in the 2009 biennium, are included in the previously discussed individual categories.

<u>Pay Plan</u>

The legislature provided both a salary increase and increased monthly insurance contributions in the 2009 biennium. Salaries were increased by 3.0 percent starting October 1, 2007 and by a further 3.0 percent starting October 1, 2008. The legislature also provided a 0.6 percent flexibility increase and a longevity change, as well as funds to bring all agencies to 80 percent of market salaries. Insurance was increased by $33 per month on January 1, 2008 and a further $36 per month on January 1, 2009. Because all increases were phased in not only during the biennium but during the fiscal year, FY 2008 only represents a portion of the costs to fully implement this pay plan in the 2011 biennium.

The total general fund cost to fully implement the 2009 biennium pay plan in the 2011 biennium is about $83.5 million, or $49.4 million over the doubled FY 2008 base. The present law adjustment reflects the difference between the total cost in the 2011 biennium and the amount already included in the individual figures above. (Please note that the figures assume 83 percent general fund for the Montana University System.)

<u>Fixed Costs</u>

"Fixed costs" are charges made to agencies for the costs of the provision of certain centralized functions of state government. Among the fixed costs are information technology services, insurance, various administrative functions such as payroll, motor pool, grounds and maintenance, and accounting system debt service. Fixed costs will rise primarily due to the net of increases in ITSD charges, and rent, partially offset by a decrease in insurance.

Vacancy Savings

Vacancy savings is the difference between the cost of fully funding positions for the entire year, and the actual cost of authorized employee positions during that period. While vacancy savings is not considered a present law adjustment, the legislature has consistently applied a vacancy savings at the rate proposed by the Governor. Consequently, a 4 percent vacancy savings is assumed in all present law calculations. Vacancy savings is about $25 million general fund over the biennium.

Inflation

The statutory definition of present law states that inflationary adjustments should be added in preparing a present law budget. However, the budget as presented by the Governor and the budget adopted by the legislature for several biennia has included not only very selective inflation adjustments, but offsetting deflationary adjustments. Primarily due to energy costs (including motor pool), fuel, and reference materials, inflation is included at $6.4 million general fund.

Statutory Appropriations

General fund statutory appropriations increase $5.6 million from the present law biennial base. The increase is due primarily to changes in retirement contributions, local government entitlements, debt service, economic development, and emergency appropriations.

- Retirement system payments based on insurance premium taxes increase $8.8 million
- Other retirement payments increase $13.5 million, partially due to no expenditures recorded in FY 2008 from a statutory appropriation for MUS employers' retirement contributions
- For the 2011 biennium, appropriations to local governments authorized by House Bill 124 (2001 session) increase $17.1 million due to increases in the statutorily calculated growth rates
- Debt service payments decrease in FY 2010 and FY 2011 for a decrease of $5.8 million
- Base appropriations for economic development decrease $5.9 million due to the termination of the programs in FY 2011.

Base expenditures for emergencies were $11.7 million. Since the $16.5 million appropriation for emergencies is accounted for in the balance sheet under "Reserves" rather than "Statutory Appropriations", there is a decline of $23.4 million.

Transfers

Transfers of money out of the general fund increase $0.5 million from the present law biennial base. The difference is due primarily to:

- An increase of $0.2 million in HB 124 (2001 session) transfers authorized in 15-1-122, MCA
- An increase of $0.3 million (the total amount for the 2011 biennium) for rural physician incentives which begins in FY 2009

Feed Bill

The "feed bill" funds the cost of the legislative sessions and other interim activities. A total $8.9 million is included for those costs in the 2011 biennium, consisting of a portion carried-forward from the 2009 session feed bill to pay interim and pre-session costs through December of 2010 and a portion from the 2011 session feed bill for costs incurred before the end of the 2011 biennium.

LFD RECOMMENDED ALLOWANCES

In addition to the projections in Table 1 that most clearly fit into the statutory definition of present law, the LFD recommends that four other adjustments be made in projecting a more realistic outlook of the funds available for the 2009 legislative session above present law funding. They include leaving an adequate ending fund balance reserve, a reserve for wildfire suppression costs, a reserve for declared emergencies, and a reserve for the unpredictable impact of the current economic crisis. Each of these issues is discussed below.

Adequate Ending Fund Balance Reserve

An ending fund balance reserve provides a cushion for variations in actual revenue collections versus projections and for unanticipated expenditures (supplemental/statutory appropriations). Statute requires a minimum ending fund balance reserve of 1 percent of total appropriations (approximately $37 million). It would not be good budget management, however, to leave an ending fund balance projection that only meets the minimum, since any negative decline from projections would trigger statutorily required budget balancing action by the executive. Plus, a 1 percent reserve for a biennial budget that is subject to significant fluctuations in revenue estimates and potential supplemental appropriation demands simply does not provide an adequate cushion for unanticipated events, especially in view of the current economic outlook.

Recently, the general fund reserve set by the legislature has been above $100 million, or over 3 percent of total biennial revenues. While a minimum reserve of 3 to 5 percent is recommended by national experts, it is recognized that in prioritizing a budget, it is difficult to attain. The Legislative Fiscal Division (LFD) suggested minimum adequate ending fund balance reserve is 3.0 percent, or $126.5 million. This amount compares to a $125 million ending fund balance reserve adopted by the 2007 legislature in special session (September 2007) for the 2009 biennium. This suggested fund balance reserve is only a guideline and is included to provide a more realistic measure of the excess funds available. Ultimately, the determination of an adequate fund balance reserve is a policy decision of the legislature. For reference, each 1 percent of reserve set-aside funds is $42.1 million.

Wildfire Suppression Costs

The present law disbursement projections in Table 1 do not include any estimate for the ever-present cost of wildfire suppression. While the legislature funded all anticipated costs in the 2009 biennium in the September 2007 special session, the legislature traditionally has not budgeted for the costs of fighting wildfires. As a consequence, the ending fund balance reserve must cover all expenses.

Given that the state incurs significant wildfire costs each year, some allowance for these costs should clearly be included in any biennium ending fund balance projection. Although the cost of fighting wildfires can fluctuate significantly from biennium to biennium, a five year average, removing the high and low years (FY 2008 and FY 2003, respectively), is $17.7 million per year. This number is used in Table 1 ($35.5 million for the biennium) to represent anticipated fire costs in the 2011 biennium. It is emphasized that this is a very conservative number, when considering that the annual costs of wildfire suppression have grown dramatically in recent years, and that federal reimbursement for wildfire costs have decreased.

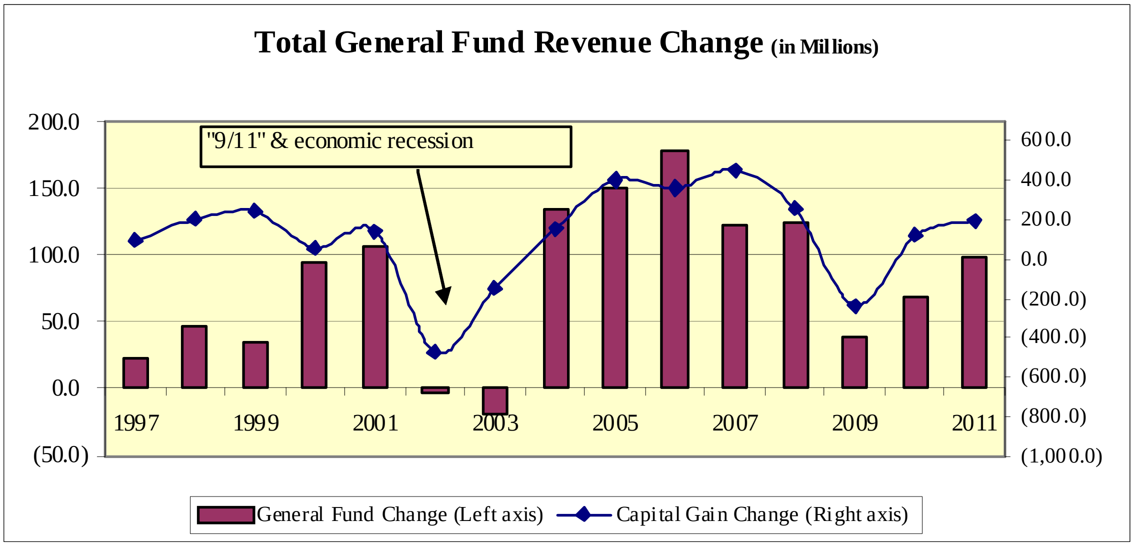
Emergency Fund Appropriation

The legislature has approved a statutory appropriation of $16.5 million general fund each biennium for the Governor to deal with declared disasters or emergencies such as floods, fires, and other natural disasters. Until last legislative session, the legislature never included any of the $16.5 million in its budget and projected ending fund balance. The 60th Legislature included the full amount. Furthermore, the 58th Legislature amended appropriations statute to clarify that the legislature must not only budget in good faith for a balanced budget, it must also achieve a positive ending balance at the end of the biennium. This change reinforced the argument that it is sound fiscal policy to include this appropriation in the projected budget and ending fund balance, just as is done for all other statutory appropriations. LFD recommends that a reserve for $16.5 million be included in the projection of the 2011 biennium available funds.

Economic Uncertainty and Revenue Trends

As shown in Table 3, total general fund revenues have increased substantially during the period FY 2004 through 2008 and are projected to increase only moderately during FY 2009, 2010, and 2011. The projected dollar increases are consistent with the trends observed from FY 1995 through 1999. From a percentage growth perspective, however, the projected increases are generally a lower percent than in that previous period. The table also shows that during FY 2002 and 2003, a reduction in revenue was experienced at the same time that capital gains and other investment income plummeted. This was due to the "9/11" tragedy and a national economic recession, a situation that could be replicated in the current economic crisis. Conversely, the table also shows that during FY 2000 and 2001, state revenue growth accelerated when the nation was experiencing rapid growth in the equity markets due to the proliferation of "dot com" companies and the effect on capital gains income.

Table 3



This data illustrates the sensitivity of Montana's revenue stream to world events and investment opportunities, which is painfully relevant in the current worldwide economic crisis. It also underscores the potential inaccuracies in the revenue estimates if the occurrences of these types of events are not known or are mistimed. Economic upturns or downturns are rarely accurately projected nor can disasters or world developments be anticipated.

To quantify current collection patterns, the increased revenue collection of $707 million from FY 2004 to 2008 was primarily due to three general fund revenue sources: individual income, corporation income, and oil and gas production taxes. Together, these three sources of revenue contributed about $568 million of the total increase, which represents over 80 percent of the total. The various assumptions used to estimate these revenue sources will have a substantial impact on total estimated general fund revenues in the future. If only a few of the key assumptions miss the mark, estimates may vary widely from actual collections. Key assumptions for these three sources are as follows:

- Montana wage and salary income
- Income from investments (capital gains, interest and dividends)
- Commodity prices (natural resources and agricultural products)
- Corporation profitability.

As stated earlier, the revenue estimates contained in this report are based on economic and accounting information available as of the end of September. For these three revenue sources however, there will be critical information that should be available in November. For example, individual income tax return data for calendar year 2007 will be available November 1. This data will help explain why individual income tax receipts have continued to grow so rapidly through FY 2008.

Because this new data could significantly change the outlook (positively or negatively) on estimated general fund revenues, the estimates contained in this report are based on the premise that the unusual high revenue growth observed in the last five years has peaked and will abate in subsequent years. This conservative approach was adopted to minimize the downside risk associated with revenue estimates that are predicting amounts almost three years into the future. If the new data supports adjustments to the estimates, revised estimates will be provided to the Revenue and Transportation Committee (RTIC) on November 17. The RTIC is statutorily responsible for establishing revenue estimates to be used by the 61st Legislature.

As a "placeholder" for the potential impact of the economic upheaval and revenue trends, staff recommends that a "reserve" be set aside from the current estimates until the effects of the unfolding economic crisis can be more reliably projected. A reserve of $275 million was calculated using downturn percentages experienced during the 2002-2003 fiscal period, and represents the potential drop in estimated state revenues if there is a significant downturn in the Montana economy.

SIGNIFICANT ISSUES NOT INCLUDED IN 2011 BIENNIUM PROJECTIONS

There are other issues (Table 2) with potential material impacts on the 2011 biennium budget for which the fiscal impacts are either uncertain or unknown, and consequently are not included in the projections. Additionally, economic events could produce unanticipated changes in revenue projections. In the event that any of these become reality, there is a potential for impacts to the general fund balance. While not included in the fund balance projections, it is important that the potential impacts be considered in the legislative deliberations to balance the 2011 biennium budget. Where feasible, a cost estimate or potential cost range is provided to assist the reader. Each item is discussed briefly below.

Other Potential 2009 Biennium Cost Over-runs (Supplementals)

While no supplemental appropriations are anticipated, there are several pressure points to note:

- The lower than anticipated Medicaid growth rate includes a data "bubble" that could have underestimated account growth trends; if Montana's economy begins to be impacted by national economic events, Medicaid costs in FY 2009 could exceed expectations.
- Fuel costs in the Montana Highway Patrol have exceeded the appropriation in FY 2008; while the department was able to cover these costs internally, it is unknown if they can be covered fully in FY 2009
- The Department of Justice did not, at the time of this writing, know the total costs for defending the state in the school funding lawsuit, which is funded from the general fund major litigation account

2011 Biennium Employee Pay Plan

As of this writing, no pay plan proposal for the next biennium has been officially discussed, and none is assumed in any of the present law calculations in this report. However, a proposal is likely to be presented to the legislature by the Governor. For purposes of perspective, each 1 percent increase in salary effective October 1 of each year of the biennium would cost about $12.5 million general fund in the 2011 biennium, with an ongoing 2013 biennium cost of about $19.3 million, assuming 83 percent general fund for the Montana University System. Each $10 per month insurance increase each year of the biennium, effective on January 1, would cost approximately $3.8 million. A vacancy savings rate of 4 percent is assumed for both calculations.

Litigation: K-12 Lawsuit – Columbia Falls v. State of Montana

On April 15, 2004, the Helena District court under Judge Sherlock declared Montana's school finance system to be unconstitutional, holding in part that "the State's school finance system must be based upon a determination of the needs and costs of the public school system, and the school finance system must be designed and based upon educationally-relevant factors."

The Supreme Court issued an opinion on March 22, 2005, affirming the court's determination that the current system violates Article X, Section 1(3) of the Montana Constitution but deferred to the legislature for the definition of 'quality' as used in that constitutional provision.

The 2005 Legislature passed and the governor signed SB 152 defining a basic system of free quality schools. The legislature also passed SB 525 creating the Quality Schools Interim Committee. The QSIC's duties included assessing the educational needs of Montana students, determining the costs of a basic system of quality schools, and constructing a funding formula that met the requirements of Senate Bill 152. In December 2005, before QSIC had finalized a funding formula, the Governor called a special session of the legislature and four new components were added to the K-12 funding formula, costing the state approximately $35.0 million for FY 2007 in ongoing state support and $33.5 million in one-time only funding. Subsequently in 2007, the legislature increased ongoing state support for K-12 for the 2009 biennium by $83.5 million, instituted full-time kindergarten, and appropriated one-time only support of $45.0 million.

In February of 2008, the plaintiffs in Columbia Falls v State of Montana filed a motion in the district court alleging that the State's school funding formula failed to provide adequate funding for FY 2009. Plaintiffs also alleged that the current funding formula does not reflect the cost of a basic quality education, that the current formula contains elements that are essentially the same as those that were suspect in the original suit, and that the new components represent only 5 percent of the statewide district general fund budget.

The case was heard in Judge Sherlock's district court the week of September 22-26, 2008. The State argued that the QSIC had determined the cost of a basic system of quality education, that the current spending levels by the K-12 system were actually above those costs, and that the changes to the K-12 system legislated in the past four years – the four new components, three year averaging of ANB, full-time kindergarten, inflation of the basic and per-ANB entitlements and special education, and increased guaranteed tax base aid – represented nearly 17 percent of 2009 district general fund budgets.

A ruling is not expected until sometime in November 2008.

Litigation: State Fund

A lawsuit related to workers' compensation claims could cost the general fund between $93 and $116 million. *Satterlee* challenges the constitutionality of terminating permanent total disability and rehabilitation benefits when a claimant receives or becomes eligible to receive full Social Security benefits or an alternative to that plan. A Montana Workers' Compensation Court judge ruled in favor of the respondents/insurers (including Montana State Fund) in December 2005. A request for reconsideration of the case was denied by the Montana Workers' Compensation Court. The case was appealed by the plaintiffs to the Montana Supreme Court. In December 2007, the Montana Supreme Court dismissed the appeal without prejudice and returned the case to the Workers' Compensation Court because the order fell short of a final judgment in that the lower court needed to address two unresolved issues. The Montana Workers' Compensation Court granted the respondents a partial summary judgment and held that statute does not violate the plaintiff's substantive due process rights because it is reasonably related to a permissible legislative objective and the statute does not unconstitutionally discriminate against the plaintiff on their age because it is rationally related to a legitimate governmental purpose. Satterlee again appealed to the Montana Supreme Court. Appellant briefs in the case are due October 10, 2008.

Litigation: Protested Property Taxes

In January 2008, PPL Montana, LLC settled their litigation over property taxes with the state. There are six more centrally assessed companies currently protesting their property taxes. They are, with the years of protest in parentheses: Northwestern Energy (2005-2007), Qwest (2007), Puget Sound Energy (2005-2007), Omimex Canada LTD (2004-2007), Pacificorp (2005-2007), and Verizon (2007).

The issues differ in each case. The total taxes for all governments are nearly $69 million, and the amount in tax year 2007 was $31 million. The state shares of these amounts are $14.7 million for all years and $6.6 million in 2007. State law requires that half of the protested taxes from centrally assessed firms must be deposited into a special revenue account until resolution of the protest.

The property tax revenue estimate in this report assumes that the amount protested in 2007 will continue to be protested in the remainder of the 2009 biennium and the 2011 biennium. The amount protested for tax year 2008 will not be known until November 2008.

Litigation: PPL Montana, LLC River Bed Fees

District Court Judge Thomas Honzel has ruled in favor of the state in its lawsuit against PPL Montana, LLC. He has concluded that the state is entitled to $40,956,180 from PPL Montana as compensation for the use of school trust lands from 2000 to 2007. The Attorney General's office states that PPL Montana will appeal to the Montana Supreme Court. A mediation hearing, as required by Supreme Court rules, will be held October 24, 2008. A related issue is how the Department of Natural Resources and Conservation will distribute the $40,956,182, if received from PPL Montana. As stated in Article X, Section 5 of the Montana Constitution, 95 percent of all income from school lands is to be distributed to elementary and secondary school districts. Newspaper quotes from the director of the Department of Natural Resources and Conservation indicate that this constitutional distribution may not be followed. The $4.0 million received from a negotiated settlement with Avista in FY 2008 was distributed 95 percent to schools.

Long Range Building Program Deficiency (LRBP)

The LRBP is the state program charged with the major maintenance of eligible state owned buildings. Funding for the program has been deficient as a result of declines in the program's revenue base, cigarette taxes and coal severance taxes, and the continued increase in both the number of square feet of state owned space and the cost of the maintenance of the space. The consequence of the ongoing funding inadequacy is a large deferred maintenance backlog. In the past two biennia, the legislature chose to address the problem of the backlog with appropriations of one-time only (OTO) general funds. In the 2009 biennium, OTO funded LRBP projects reduced the backlog by an estimated $66.5 million, providing a reduced backlog of approximately $138.5 million. While the appropriations of the past two biennia have reduced the backlog, the issue of inadequate funding for the maintenance of state building continues. If the policy of funding the LRBP with OTO dollars does not continued, the backlog will continue to grow. Growth in the deferred maintenance backlog cannot be contained without a resolution to the funding inadequacy in the LRBP.

Condition of the State Pension Funds

The most recent actuarial valuations of the pension plans (as of June 30, 2008) shows eight of the nine plans comfortably within the 30-year amortization requirement for "actuarial soundness" as defined in statute. Only the Teachers' Retirement System has an amortization period that exceeds the 30-years, at 31.3 years. All plans and particular the four plans that were the focus of efforts to shore them up have seen marked improvement as a result of legislative actions and some extraordinarily good investment returns in FY 2007. <u>However</u>, pension funds, with total assets in excess of $8 billion as of June 30, 2008, have been subject to the impact of an increasingly troubling U.S. and global economy. As of this writing, while the impact to the pension funds is not available yet, equity markets have fallen dramatically, the bond market is weakened, and even the return on treasury notes is down. The financial health of pension funds might not be a primary focus of the 2009 Legislature but the long-term outlook will undoubtedly be on the minds of legislators and will depend upon how quickly the equity markets and other investment categories can recover.

State Fund "Old Fund" Liability

The Montana State Fund provides Montanan Employers with an option for workers' compensation and occupational disease insurance. Prior to 1990 workers' compensation experienced significant liabilities. The legislature restructure the state fund, and separated state fund liabilities between claims occurring before July 1, 1990 and claims occurring on or after that date. Funds relating to claims prior to July 1, 1990 are referred to as "Old Fund". Statutes require that in any fiscal year where claims for injuries form accidents occurring before July 1, 1990 (Old Fund) are not adequately funded, the funds must be transferred from the general fund. As of June 30, 2008, the estimated liabilities exceeded assets by $36.1 million. As this time, the Old Fund has sufficient invested assets to meet its obligations until the year 2012, when general fund may need to offset this shortfall.

Ballot Initiative – I-155 Montana Healthy Kids

If approved by the voters, Initiative 155 would establish the Montana Healthy Kids plan to expand and coordinate health coverage for uninsured children under the Children's Health Insurance Program (CHIP), the Montana

Medicaid Program, and employer-sponsored health insurance. Funding for I-155 would come from a share of the insurance premiums tax, currently deposited to the general fund, and federal matching funds. Since the initiative would be effective upon approval by the electorate, general fund revenues would be reduced by $17.7 million in FY 2009 and $44.3 million in the 2011 biennium.

Federal Funds

Montana relies heavily on funding from the federal government for a number of state services. Federal funds are used throughout state government, most notably in human services, environmental and wildlife programs, and transportation. Therefore, any change in discretionary federal spending could have a major impact both on individual programs and the state in general. The federal government is currently facing an extremely large budget deficit. Therefore, it is entirely possible that major adjustments will be made as Congress and the President deal with this reality in the post-election environment. Because work on the federal budget is often delayed until long after the start of the federal fiscal year (October 1), major changes in federal policy and funding levels are often not confirmed until either just before or even during the legislative session. The legislature may be faced with budget items that reflect known or anticipated changes due to federal action, including replacement of lost or reduced funds, and adjustments in programs to reflect changing fund availability.

Inflation/Energy Prices

In keeping with past legislative practices, this report does not include a general inflation amount. Instead, certain individual expenditure items are inflated, most notably energy, fuel, and related expenditures. While fuel prices are stabilizing and/or falling at the time of this report, the markets are volatile and lend a high degree of uncertainty to this component of state expenditures.

New Proposals and Other Initiatives

In every biennium, the governor requests and the legislature approves increases beyond the present law budget, referred to as "new proposals." In addition, an employee pay plan and various legislative initiatives are considered and approved. In recent biennia, the total cost of such items has ranged from $78 million to $305 million (excluding one-time-only initiatives, which have been as high as $490 million). Since funding for expanded programs and services is not a present law service and is a matter of legislative policy and prioritization, no estimate is included in the 2011 biennium present law projection. In the context of preliminary budget projections, the legislature needs to be aware of the potential, based on historical data, of such requests. Some new proposals, including the pay plan, are discussed separately.

Tax Relief/Rebate Measures

By definition, present law levels represent the amount necessary to continue programs and services authorized by the previous legislature. While this definition is relevant to general fund disbursements, this report is also developed on this definition for tax structure or policies. Any proposed tax relief, rebate, or reform proposal would be considered a new proposal or initiative and has not been included in this report

Interest Earnings

Excess cash in the state treasury is invested by the Board of Investments and generates general fund interest revenue. The calculations in this report are based on a budgeted ending fund balance by the legislature of $125 million for the 2011 biennium. If the legislature appropriates general fund monies above the present law base, timing of the spending may impact invested funds and revenue from this source will be impacted accordingly.

STRUCTURAL BALANCE

Structural balance refers to the matching of ongoing expenditures of government with ongoing revenues. If anticipated ongoing revenues equal or exceed expenditures, then structural balance is achieved. If expenditures exceed anticipated ongoing revenues, a structural imbalance occurs. Beginning fund balance is not included in the calculation, since any use of the balance is a one-time source of funds.

As shown in Table 1, the present law excess after reserves is projected to be $778.6 million based on current data for the 2011 biennium, or $503.1 million if you apply the reserve for the as yet unpredictable effects of economic uncertainty. However, as in the 2007 session, it is critical to analyze the structural balance of the general fund account before a conclusion can be drawn about whether additional funds are appropriate for state services and/or tax policy initiatives of an ongoing nature.

For the 2011 biennium, anticipated revenues are expected to exceed present law disbursements by $421.9 million. The remaining balance is also available for legislative consideration but should be used only for one-time initiatives if a structural balance is to be maintained. To the extent the 61st Legislature uses any of the amount over $421.9 million for on-going initiatives, it could result in a deficit budget picture for future legislatures.

Table 4 shows a simplified general fund balance sheet for the 2011 biennium and a hypothetical example for the 2013 biennium assuming a 3.0 percent growth in revenues and disbursements. This table illustrates that if the $356.8 million present law excess (excluding a reserve for economic uncertainty) is used for one-time initiatives during the 2011 biennium, the 62nd Legislature will not be faced with an anticipated deficit, assuming disbursement growth is kept in concert with revenue growth.

This is a relevant example for the next biennium, but if a downturn lasts beyond that biennium, a structural balance may not be achieved without additional action.

Table 4

General Fund Account Balance Statement

Balance Statement Components	**Outlook 2011 Biennium Millions**	**Illustration 3% 2013 Biennium Millions**
Beginning Fund Balance	**$483.309**	**$126.514**
Present Law Revenues	4,217.137	4,343.651
Present Law Disbursements	(3,743.323)	(3,855.623)
Emergency/Wildfire Reserve	(51.994)	(53.554)
New Initiatives - Ongoing	(421.820)	(434.475)
New Initiatives - One-Time	(356.795)	0.000
Ending Fund Balance 3.0 percent of biennium revenue	**$126.514**	**$126.513**

SUMMARY

The 61st Legislature inherits a present law excess fund balance similar to the record amount inherited by the 60th Legislature in the 2007 session. Yet the economic outlook for the 2011 biennium is dramatically different. The fund excess is primarily due to strong growth in individual and corporate income tax and oil and gas tax revenues during the previous 2004 through 2008 period. The projected present law ending general fund balance for the 2011 biennium is $778.6 million with an allowance for a 3.0 percent ending fund balance reserve and allowances for fire suppression and emergency appropriation costs. However, current estimates do not capture the full impact of the current economic crisis. Therefore, the balance is reduced to $503.1 million when allowing a reserve for the unpredictable impacts of a more severe economic downturn. It is emphasized that this is a conservative and responsible estimate for planning purposes, but as more information becomes available before the 2009 session, the available balance could change significantly. This balance leaves the 61st legislature with significant flexibility when prioritizing a present law budget and more opportunities when considering new initiatives, including both new programs and tax policy changes. It is important to keep in mind, however, that there are a number of issues, listed in Table 2 and discussed beginning on Page 11, with potential material impacts on the 2011 biennium budget that are not included in the projections. The fate of these potential issues could significantly reduce the funds available for the 2011 biennium budget prioritization process. In addition, the legislature needs to keep in mind the objective of maintaining a structurally balanced general fund. If structural balance is to be achieved, it is important to note that not all of the projected balance would be available for initiatives and funding of an ongoing nature. Only $421.8 million would be available for ongoing expenditures, while the remainder should either be held in reserve or used for one-time expenditures. Additionally, the legislature should consider the potential length of an economic recession when establishing the budget policy for the use of the excess fund balance, and the sustainability of the state present law budget in future biennia if the economic downturn continues beyond the 2011 biennium.

APPENDIX A

BASIC ASSUMPTIONS USED IN PRESENT LAW PROJECTIONS

Concept of Present Law

The provision of a present law budget projection represents a starting point for legislative budget deliberations, and complements the statutory requirement that the executive and legislative staff present/analyze a present law budget. Present law is defined as "that level of funding needed under present law to maintain operations and services at the level authorized by the previous legislature…" Present law serves as a benchmark to aid the legislature in prioritizing budget issues between maintenance of existing services and provision of new services or tax policy initiatives. The projection of a present law budget does not presume the legislature will adopt a budget that retains all existing services. But the executive must present a present law budget to the 2009 Legislature, and both new initiatives and reductions or adjustments in existing services must, by law, be presented as new proposals for the legislature to consider in crafting a budget.

Present law projections include 2011 biennium fund balances at present law operations. Present law is used rather than actual FY 2008 expenditures in order to account for inflation and other costs, such as annualization of the state employee pay plan. It is also used because statute requires the executive to submit a present law budget, and the LFD to provide a present law analysis. Present law expenditures are at the levels established by the legislature in the 2007 regular and special sessions for ongoing services, with adjustments for caseload and enrollment increases. Changes in employee pay for market adjustments, promotions, and other adjustments made by agencies are also included. The present law projections do not include funding for increases in adjustments to the K-12 Base aid funding schedules or human services provider rate changes beyond the changes made by the 2007 Legislature. No funds are included for new programs, tax policy revisions, or legislative initiatives.

Revenues

Revenues included in the 2011 biennium projections are estimated collections under state and federal law and accounting procedures, with the rates and allocation percentages as specified under current law. The projected revenues for FY 2009 through 2011 contained in this report are preliminary estimates, based on FY 2008 actual collections and current economic trends. These revenue projections will be subject to more in-depth analysis and refined later in calendar 2008, as the Revenue and Transportation Interim Committee undertakes its statutory duty to prepare a revenue estimate for presentation to the 2009 legislature. The potential effects of the current economic upheaval will also become more predictable as the situation unfolds.

It should be noted that the complexity in estimating individual income taxes is especially difficult for this budget cycle. The most recent tax return data available for analysis is CY 2006. The CY 2007 data will not be available until early November.

In addition to dated data, another complexity involved in estimating individual income taxes is the volatility in capital gains income. The continual up and down swings of the equity markets makes the task of estimating income levels from this component extremely difficult. Because of the varying fluctuations, taxpayer behavior changes can be a significant factor that is almost impossible to incorporate into the simulation model. If the model cannot be adjusted appropriately, less reliable methods must be used.

Expenditures

Actual expenditures in FY 2008 are used as the starting point for base expenditures. Actual expenditures, minus one-time-only expenditures, were doubled to provide a base from which present law increases were calculated.[1] The following additional general adjustments were made in projecting present law costs into the 2011 biennium:

- Personal services costs are at the level of FTE used to calculate 2009 biennium personal services costs by the 2007 Legislature, with adjustments to reflect continuation of the 2009 biennium pay plan into the 2011 biennium and market and other adjustments made by the agencies
- Anticipated enrollment changes in K-12 and the university system have been included
- Caseload and entitlement adjustments in human services and corrections programs (including Medicaid and prison population) anticipated under present law are included
- Budget modifications and miscellaneous ("cat and dog") appropriations enacted by the 60th Legislature are excluded if they were designated as one-time expenditures, while those funding ongoing duties are included in the present law projections
- Appropriations phased in during the 2009 biennium are funded for the entire 2011 biennium (e.g., pay plan)
- Vacancy savings is taken as a reduction from total personal services to reflect that, due to position vacancies and other personnel policies, less than full funding of personal services is sufficient to meet agency employment obligations. Historically, the legislature has implemented some form of vacancy savings, and the typical average vacancy savings rate adopted in legislative budgets in recent biennia is 4 percent (the percentage used in this projection)

[1] The same methodology is used in the general fund status sheet during the legislative session.