PRELIMINARY BUDGET OUTLOOK FOR THE 2013 BIENNIUM

A Report Prepared for the
61st Legislature

By
Legislative Fiscal Division

February 24, 2010

Legislative Fiscal Division

www.leg.mt.gov/css/fiscal

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DISCLOSURE

The work included in this report is the independent work of the Legislative Fiscal Division (LFD). The executive branch policy choices to balance the budget are not included. The executive branch balanced budget recommendation is not due until November 15, 2010. To the extent possible, the Governor's Office of Budget and Program Planning (OBPP) recommendations to reduce spending in the 2011 biennium within the parameters of MCA 17-7-140 are included in this analysis.

This analysis, like all forecasting, requires assumptions. The major assumptions are included in this report.

EXECUTIVE SUMMARY

The current level of service that state government provides today is approximately 10 percent higher than can be funded with the current level of revenues. The primary driver for this budget gap is falling revenues. Revenues fell 7.5 percent in FY 2009 and are currently on course to fall 12.0 percent in FY 2010. This level of revenue reduction has not been seen at least for the past four decades. The secondary reason for the budget gap is the fall in the stock market that caused the pension systems to be underfunded by approximately 25.0 percent of their value.

Key points outlined in this report:

1. The LFD does not anticipate that Montana will be able to "grow" out of the budget gap. Revenues are not anticipated to return to the previous levels until FY 2015. Substantial changes in revenues or expenditures will be necessary.

2. Expenditures include the present law services which meet the definition in statute and those expenditures needed to meet current service levels. Several temporary service or rate enhancements were included in the 2011 budget. To the extent that these one-time services will add to the pressure on the 2013 budget, they have been included in this analysis.

3. The pension system costs are assumed to fund the actuarial required contribution in the 2013 biennium. This option provides the current level of benefits to employees. The solution adopted by the legislature could be addressed in other ways:
   - Reduce the payment in the 2013 biennium to the pensions and increase the later biennium payments
   - Reduce benefits to employees
   - Increase contributions of employees
   - Other methods of reducing the costs

4. Reductions in services are addressed briefly for both state government and state and local partnerships. To provide a perspective on what 10 percent means, a breakdown of general fund spending and the relative 10 percent level is included. More specifics will be discussed in the breakout sessions of the Training Day.

The following table shows the balance sheet for projected revenues and expenditures.

Legislative Fiscal Division - General Fund Outlook Figures in Millions	2009 Biennium	2011 Biennium	2013 Biennium	Biennial $ Change
Beginning Fund Balance	**$543.541**	**$391.964**	**($63.651)**	**($455.615)**
Revenue				
LFD Revenue Estimate	3,761.508	3,252.416	3,571.548	319.132
Total Funds Available	$4,305.049	$3,644.380	$3,507.897	($136.483)
Disbursements				
General Appropriations - HB2	3,398.123	3,174.883	3,352.403	177.520
Statutory/Transfers	695.628	500.232	415.275	(84.957)
Other Appropriations	-	37.770	0.740	(37.030)
Feed Bill	-	13.537	13.027	(0.510)
Reversions	(164.732)	(11.682)	(3.883)	7.799
Total Disbursements	$3,929.019	$3,714.740	$3,777.562	$62.822
Fund Balance Adjustments	15.934	6.709	-	(6.709)
Ending Fund Balance Before Other Issues	**$391.964**	**($63.651)**	**($269.665)**	**($206.014)**
Other Fiscal Issues				
Executive Spending Proposals	-	76.376	26.160	
Executive Revenue Proposals	-	3.832	-	(3.832)
Federal Clawback	-	8.363	-	(8.363)
Current Service Level Impacts	-	-	(148.386)	(148.386)
Retirement Funding	-	-	(68.605)	(68.605)
Total Disbursements	3,929.019	3,630.001	3,968.393	$338.392
Ending Fund Balance After Other Issues	**$391.964**	**$24.920**	**($371.925)**	**($396.845)**
Structural Balance Calculation			($423.005)	
Fiscal Policies Required to Achieve $100 Million Balance			($471.925)	

Other Fund Balance Issues

- Supplemental Appropriations
- Pending Litigation
- Otter Creek Coal Leases
- PPL Inc., River Bed Lease Payments
- Federal Enhanced FMAP Rate Extension

The next three sections of this report outline the economic overview, revenue, and expenditure assumptions needed to calculate the budget gap. The “Balance Sheet” section gives the highlights of what can be learned from the balance sheet. It then examines the types of expenditures that equate to 10 percent of total revenues. Changes in revenue are not addressed in this report.

Note that as economic conditions evolve, all of the numbers contained in this report will continue to change. Updates of the numbers will be available periodically between now and the 2011 session. Under any scenario, the choices the legislature will face in the next biennium will be difficult. Research and better understanding of the options could improve the choices available for the legislature to consider.

ECONOMIC OVERVIEW

The general outlook for the US and Montana’s economy for the next 3 years is for modest improvement as the nation recovers from the “Great Recession”. Montana’s economy and state revenues are affected by national conditions beyond its control including prices for oil and natural gas, coal and metals. Interest rates, global commodity demand, capital gains, and profits of national corporations are major drivers that determine a large portion of the state’s general fund revenues. These and many other economic indicators are used to forecast revenue for the fiscal period 2011 – 2013. Revenues are forecast to increase from FY 2010 levels during the fiscal period of 2011 through 2013.

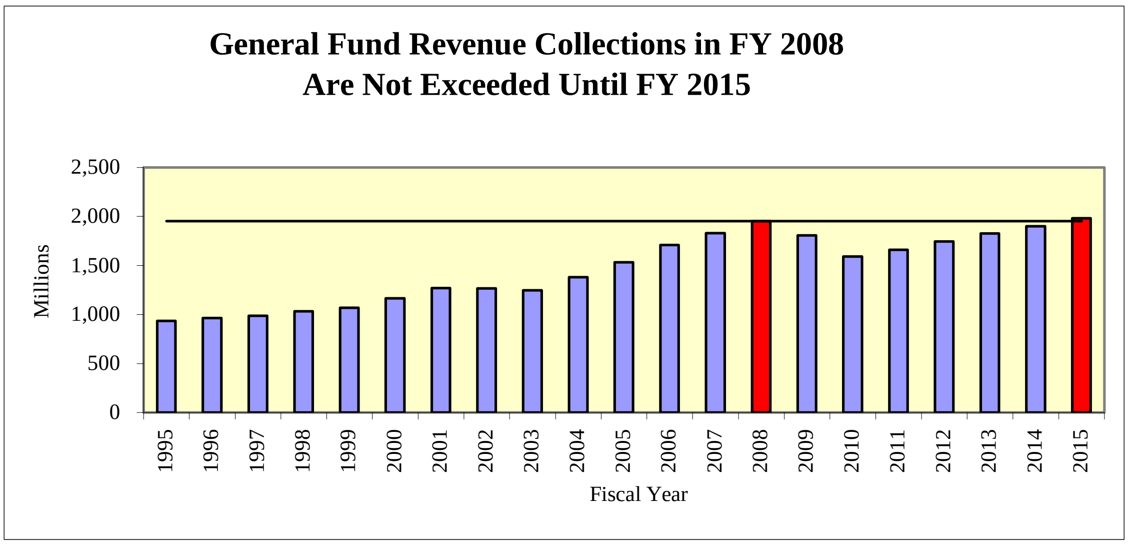
Many economic indicators have changed as rapidly as the economic climate worldwide. In April, the 61st Legislature adopted economic assumptions and accompanying revenue estimates that appeared to be reasonable at the time. Since then, state revenues have deteriorated further and the LFD revenue staff has updated the revenue estimates based on changes to year to date revenue collections as well as key economic indicators.

These indicators are: wages and salaries, long and short-term interest rates, commodity prices, and corporate profits. More details are included in Appendix A: Major Economic Assumptions.

REVENUE ASSUMPTIONS

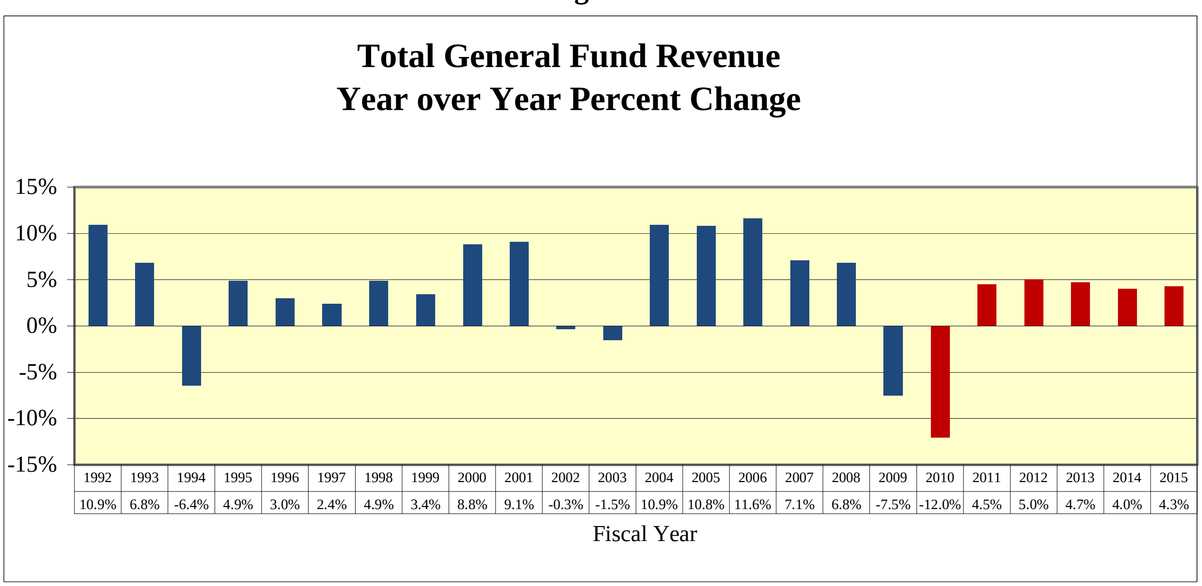
Major revenue contributors to the state general fund (and interrelated state special funds) are experiencing significant declines from FY 2008 levels. These declines are expected to continue through FY 2010 before increasing, but will still be below the FY 2008 level by FY 2013. As shown in Figure 1, general fund revenue collections peaked in FY 2008, but have declined significantly in FY 2009 and FY 2010. General fund revenues are expected to begin a recovery in FY 2011, but are not expected to reach FY 2008 levels until FY 2015.

Figure 1



The economic conditions that have prevailed since late 2008 in the state, nation, and world economies have caused state revenues to plummet from the FY 2008 amounts.

Figure 2



As shown in Figure 2, general fund revenues declined by 7.5 percent in FY 2009 and are projected to decline an additional 12.0 percent in FY 2010. Such unprecedented back to back declines have not occurred for over four decades. The only period when two consecutive years of decline occurred was in FY 2002 and 2003, but at a modest 0.3 and 1.5 percent, respectively. Such unprecedented declines also complicate the accurate prediction of future revenues and hence, complicate the budgeting process faced by the next legislature.

As shown in Figure 2, general fund revenues are expected to increase beginning in FY 2011, but at a more modest rate than observed from FY 2004 through FY 2008. These estimates are based on the IHS economic forecasts previously discussed. The economic forecasts as prepared by IHS reflect an economic recovery that will be slow and gradual throughout the forecast period. In Appendix B, the LFD general fund revenue estimates for the five major sources are discussed.

THE LFD GENERAL FUND REVENUE OUTLOOK

The LFD general fund revenue estimates for the five major revenue sources are shown in Figure 3. The economic forecasts as prepared by IHS have been incorporated into these estimates when appropriate. Revised estimates for FY 2010 and FY 2011 are shown as well as estimates for FY 2012 and FY 2013. The revised estimates for the 2011 biennium are $349.9 million less than the HJ 2 estimates prepared by the 61st Legislature.

Figure 3

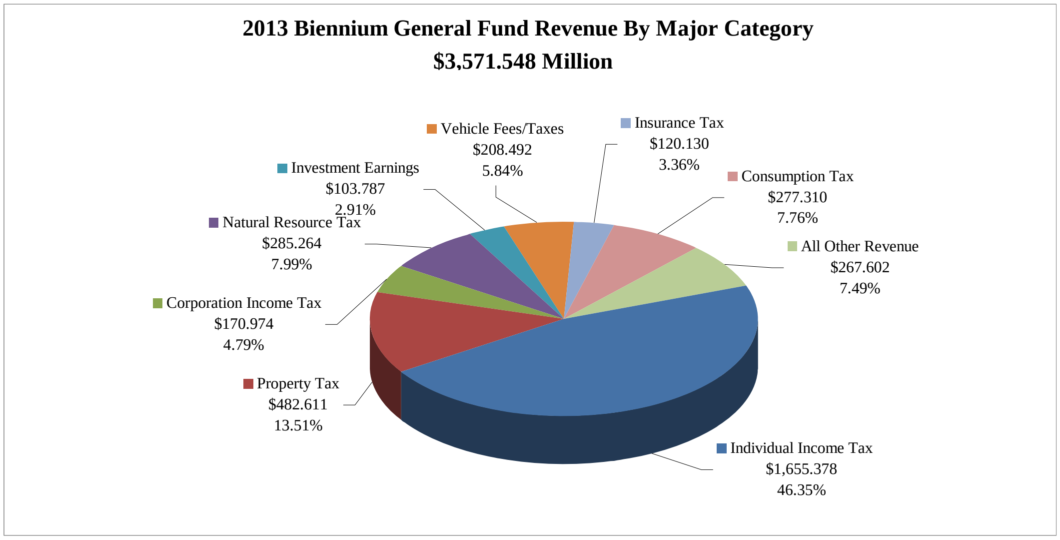
LFD Revised Revenue Estimate Recommendations - General Fund

Figures in Millions

	Actual FY 2009	Estimated FY 2010	Estimated FY 2011	Estimated FY 2012	Estimated FY 2013	2011 Biennium	2013 Biennium	Biennial $ Change	Biennial % Change
Individual Income Tax	$815.138	$722.166	$757.707	$801.321	$854.057	$1,479.873	$1,655.378	$175.505	11.86%
Property Tax	217.042	225.611	232.042	239.082	243.529	457.653	482.611	24.958	5.45%
Corporation Income Tax	166.355	57.392	68.630	79.868	91.106	126.022	170.974	44.952	35.67%
Vehicle Tax and Fees	104.678	103.211	102.473	103.778	104.734	205.684	208.512	2.828	1.37%
Oil and Gas Production Tax	100.491	88.269	94.726	95.174	91.84	182.995	187.014	4.019	2.20%
Remaining Sources	404.264	394.182	406.007	425.686	441.373	800.189	867.059	66.870	8.36%
Total	$1,807.968	$1,590.831	$1,661.585	$1,744.909	$1,826.639	$3,252.416	$3,571.548	$319.132	9.81%

Figure 3 shows the LFD revenue estimates for the 2013 biennium by the major revenue components. As shown, individual and corporation income taxes account for over 51 percent of the total anticipated revenues while property and vehicle taxes account for over 19.0 percent of the anticipated income. All together, individual, corporation, property, vehicle, and natural resource taxes contributed 75.7 percent to the total estimated revenues in the 2013 biennium.

Figure 4



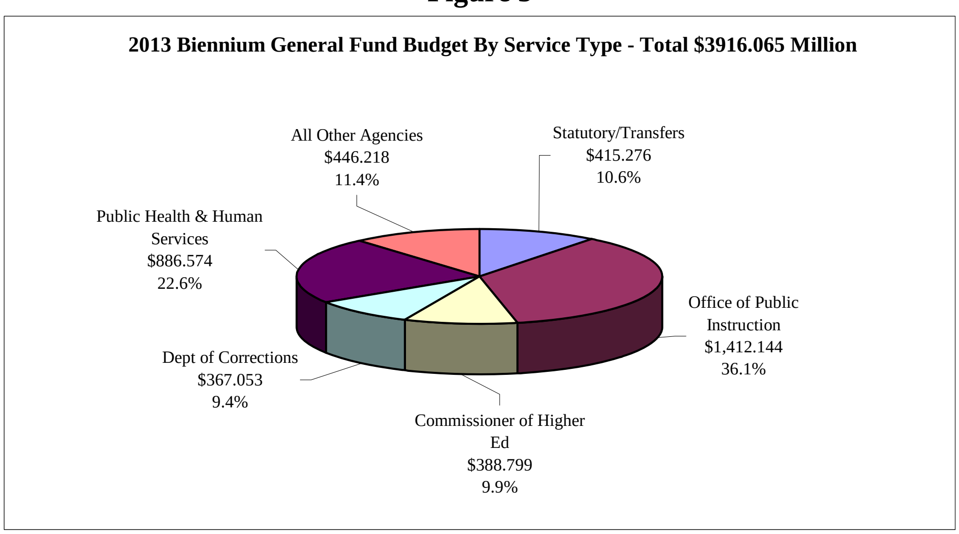
LFD Forecast for Major General Fund Revenue Sources

Appendix B presents the details on five of the major general fund revenue sources that comprise 75.4 percent of the total general fund revenue for the 2011 biennium and 75.7 percent for the 2013 biennium. The LFD has revised assumptions for all of these sources in addition to all remaining sources. These revisions for the major sources are reflected in the information in Appendix B.

SUMMARY OF EXPENDITURES

General fund expenditures in the 2013 biennium are projected to total $3.9 billion from the 2011 biennium level. Figure 5 shows expenditure projections for the 2013 biennium for current service levels by function. Note that this chart excludes carryover, feed bill, and potential appropriations for the pension issues discussed in Appendix D.

Figure 5



As shown in figure 5, 78.0 percent of all projected general fund expenditures are made in three areas:

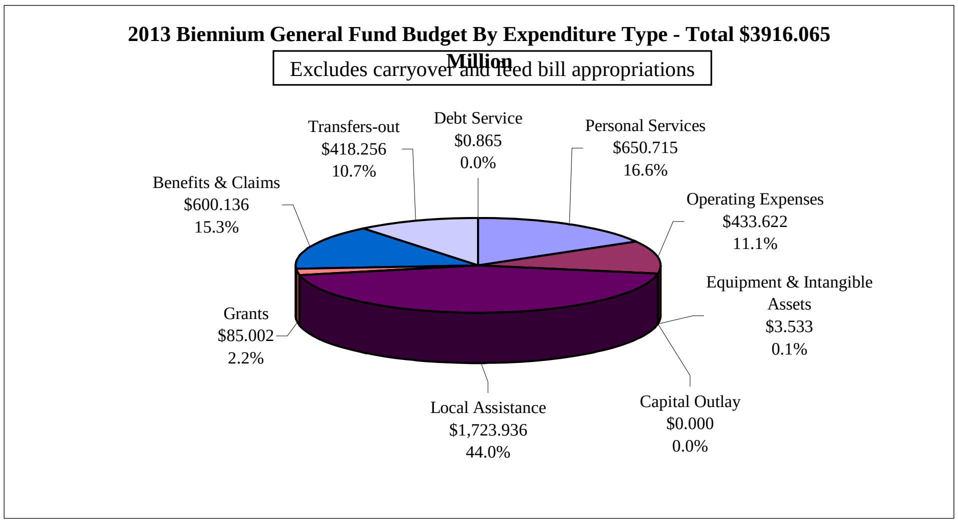
- Education, consisting of both the Office of Public Instruction (K-12 education) and the Commissioner of Higher Education - 46.0 percent
- Department of Health and Human Services (DPHHS) - 22.6 percent
- Corrections - 9.4 percent.

Statutory appropriations, which are controlled by statute and not routinely examined by the legislature, along with transfers from the general fund, are over 10 percent of all general fund expenditures. Statutory appropriations and transfers are dominated by two types of expenditures:

- Entitlement share payments to local governments
- Payments for local fire, police, and teacher retirement costs

Figure 6 shows total projected general fund expenditures by type.

Figure 6



- Local assistance, which consists primarily of BASE Aid and other assistance to school districts, and entitlement share payments to local governments, at 44.0 percent comprises not only the single largest expenditure, but almost half of the total
- Personal services costs of state employees comprise the next largest total at 16.6 percent. Please note that local assistance payments are used by school districts and local governments in part to support personal services at the local level
- Benefits are 15.3 percent and are dominated by Medicaid benefits in human services, which are used to reimburse service providers such as physicians, hospitals, nursing homes, and group homes for services to the state's low income families and aged, blind, and disabled
- All but a small portion of transfers-out are transfers to the units of the Montana University System for operating expenditures. Of the total transferred, approximately 76.0 percent is used to support personal services in the university system

The following discussion details the assumptions used in the calculations.

ASSUMPTIONS FOR EXPENDITURES

A number of assumptions were used to derive the current level of service for expenditures. "Current level of service" is defined as that level of funding necessary to maintain the services provided in FY 2011. It consists of two components:

1. Those expenditures used to fund functions of state government designated as ongoing by the legislature. These expenditures are considered "present law" and will be included in the base used to build the 2013 budget.

2. Certain expenditures designated as one-time-only (OTO) by the legislature that fund current services. These expenditures will not be included in the budget base for the 2013 biennium, but would result in a loss of services if they are not funded. The legislature will likely be under pressure to continue many if not all of these services.

Note that these amounts would be reduced if the Budget Director's recommendations to the Governor under MCA 17-7-140 impact the current level of service offered in FY 2011.

In addition employer contributions necessary to achieve 30 year actuarial soundness in the state and teacher's retirement systems are included in the calculations and discussed.

MAJOR PRESENT LAW ADJUSTMENTS

A number of different types of adjustments were made to expenditures to derive current level of service costs for the 2013 biennium.

General Increases/Decreases

- Removal of OTO expenditures, including all HB 645 (federal stimulus) funds - $272.4 million (including $227.6 million in HB 645)
- Minor inflation for:
  - A small adjustment for increases in personal services benefits, including unemployment insurance and workers compensation
  - A slight increase for certain fixed costs such as tort claims and information technology
  - No other inflation except for statutorily required additions in K-12 education (see below)
- Annualization of the benefit increases provided by the 2009 Legislature for health insurance (the one-time payment to employees paid less than a statutory threshold was OTO and eliminated) - $3.7 million
- An increase to return to 4 percent vacancy savings from the OTO 7 percent adopted by the 2009 Legislature – $15.9 million for the biennium
- Maintenance of the 2009 biennium 2 percent across the board general fund reduction
- Funding with general fund those federal stimulus funds that had been used to replace general fund for ongoing expenditures in education and human services in the 2011 biennium and for which the legislature authorized the replacement - $118.1 million each year from the base year or $201 million from the 2011 biennium to the 2013 biennium.

Caseload Increases

Costs were adjusted for projected caseload changes in a number of areas.

- Human services – Medicaid, foster care, and subsidized adoption - $43.8 million[1]
- Corrections – Overall populations are anticipated to increase by about 3.3 percent, adding $24 million over the biennium. The projection assumes the department will be able to maintain a ratio of about 80 percent community to 20 percent secure care supervision
- K-12 Education – Enrollment increases of 0.17 percent in 2012 and a further 0.76 percent in 2013, as well as statutorily required inflation and Base Aid payments - $63.6 million

Appendix C provides a more detailed discussion of these areas and the Montana University System.

CURRENT SERVICES FUNDED WITH OTO APPROPRIATIONS

A number of OTO expenditures that fund current services and for which the legislature is likely to be under pressure to fund were included. The following are the major adjustments made. A number of other minor adjustments were also included.

[1] LFD utilized DPHHS Medicaid general fund estimates in the 2013 biennium.

- K-12 Education – Funding of at-risk payments, continuance of the OTO 2 percent entitlement components, and special education - $35.5 million
- DPHHS – Child care and provider rate increases, direct care worker wage increases, organ transplants, aging services, vocational rehabilitation state grants, IDEA part C, and several other adjustments - $67.9 million
- Montana University System – Tuition and 6 mill levy mitigation and restoration of the community college executive budget – $27.7 million
- Department of Commerce – Various economic development programs – $6.6 million
- Various other appropriations throughout state government - $10.7 million

PENSION FUNDS

Funds were included to bring the various pensions funds to a 30-year actuarial soundness using employer contribution increases, only. The State Administration and Veteran's Affairs Interim Committee is in the process of analyzing other options, but they are not available at this time. More detailed analysis and assumptions are included in Appendix D of this report.

- General fund impact of $68 million in the 2013 biennium and $93 million in the 2015 biennium
- Other state funds impact of $94 million in the 2013 biennium and $115 million in the 2015 biennium
- Local government impact of $72 million in the 2013 biennium and $81 million in the 2015 biennium
- School mill levy impact of $70 million in the 2013 biennium and $124 million in the 2015 biennium

OTHER ADJUSTMENTS

- Fire costs are assumed to be funded with the Governor's emergency fund ($16.5 million for all disasters)
- The workers' compensation "old fund" will require a general fund transfer of $16.5 million
- Any ongoing savings due to the OBPP recommendations to the Governor under 17-7-140, MCA are continued, totaling $26 million in 2013 biennium.

NOT INCLUDED IN THE CALCULATION

A number of other issues the legislature will likely address are not included in the calculations. Therefore, any additional costs for these items will add to the projected negative fund balance.

- State employee pay plan or health insurance increases
- Fire costs beyond the amount in the Governor's emergency fund
- Any potential lawsuit settlement costs (see "Potential Lawsuits" later in this report)
- Inflationary adjustments for provider rates, rents, food, fuel, or other contracts
- Water compact distributions to the Blackfeet or Gros Ventre tribes
- Supplemental appropriations[2]
- New proposals

For a further discussion of adjustments made by functional area, see Appendix C.

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[2]While the 2013 biennium projections do not include any potential supplemental appropriations, two potential supplemental appropriations are factored into the 2011 biennium projected expenditures:

1) $20 million ($10 million each year) for the Department of Public Health and Human Services (DPHHS), based upon the current estimate used for planning purposes by the department. OBPP has indicated that the entire amount will be mitigated in the 2011 biennium and no supplemental appropriation will be requested.
2) $2 million ($1 million each year) for the Office of the Public Defender, based upon current estimates of cost overruns in FY 2010. On February 23, 2010, OBPP preliminarily indicated that, pending legislative review, it would process a supplemental transfer. As of this writing, the request has not been received.

POTENTIAL LAWSUITS

No potential costs due to current or anticipated lawsuits are included in the 2013 biennium projections. However, three cases with the potential for additional state costs are highlighted.

1) South Pointe –The state is the sole defendant in a lawsuit filed due to the termination of three leases on what would have been the South Pointe subdivision in the Nob Hill area in Helena. The subdivision would have housed a portion of several state agencies. The state is currently in the discovery phase.
2) Libby – the state is one of a number of defendants in a lawsuit brought on behalf of current and former residents of Libby for asbestos related damages. There are no current estimates of a resolution date.
3) Blanton – A class action lawsuit challenges the right of the Department of Public Health and Human Services to assert a lien on payments from third parties to Medicaid recipients to compense them for injuries or illness for which the Medicaid program has made payments to medical providers. As of this writing the court has determined that DPHHS must makes refunds, but no final judgment has been made and an appeal may be considered.

BALANCE SHEET

The fund balance shown below includes the above assumptions for revenues and expenditures. The current balance sheet assumes no legislative action other than those contained in the executive spending proposals or the Budget Director's recommendations to the Governor and as a result does not balance at this time.

The sections can be broken down as follows:

- Fund balance carried forward from the previous year's ending fund balance
- Current revenue estimates of the Legislative Fiscal Division
- Disbursements under a present law base technical budget analysis. Note that these disbursements assume service reductions from the 2011 biennium level.
- Fund balance adjustments are technical accounting adjustments of both revenues and expenditures
- "Other Fiscal Issues" include five additional sections:
    - Executive spending proposals are the Budget Director's recommendations to the Governor for spending reductions under 7-7-140, MCA recommended legislative changes, and recognition of Tier 3 enhanced FMAP for FY 2010 and Tier 2 enhanced FMAP for the first six months of FY 2011. (Note the OBPP assumptions differ slightly from those of the LFD and will be included in the LFD analysis of the budget director's recommendations)
    - Recent federal prescription drug "clawback" calculation has been determined to be eligible for enhanced FMAP and reduces the state general fund payment for Medicare prescription drug savings to state Medicaid programs
    - Supplemental appropriations are uncertain at this time and are not included in the balance sheet.
    - Current level service impacts as described in the expenditure assumption section bring expenditures up to the level needed to provide the FY 2011 level of services
    - Retirement funding needed to bring the pensions up to the annual required contribution level in the 2013 biennium without reducing benefits to employees or other cost saving items. See Appendix D for more information.
- Total disbursements
- Ending fund balance is the anticipated remaining balance in the general fund. Note that this number does not include additional actions needed by the legislature to balance the budget.
- The structural balance calculation is the result of subtracting current year revenues from current year expenses. The result is a "budget gap" of about $200 million, or ten percent of expenditures.
- Fiscal policies required to bring the fund balance up to $100 million equal $472 million.
- Other fund balance issues outline several areas that could affect the ending fund balance. None of these items affect the long-term budget gap, but they can improve the ending fund balance.
    - Supplemental appropriations and pending litigation are discussed in the expenditure section

- Otter Creek Coal leases – the Land Board has reissued a Request for Proposal at a lower bid requirement. If there is a successful bidder, the general fund balance is anticipated to benefit by $82 million.
- PPL Inc., River Bed Lease Payments are currently being considered by the state Supreme Court. If the state is successful in that litigation, the general fund balance will benefit by between $18 million and $63 million.
- Federal Enhanced FMAP rate extension – if the Congress authorized extension of federal enhanced payments for Medicaid in the second half of FY 2011, it will reduce the general fund necessary to fund Medicaid. This extension could be worth up to $40.0 million in the general fund balance.

Legislative Fiscal Division - General Fund Outlook

Figures in Millions

	Revised FY 2010	Revised FY 2011	Estimated FY 2012	Estimated FY 2013	2009 Biennium	2011 Biennium	2013 Biennium	Biennial $ Change
Beginning Fund Balance	$391.964	$138.285	($63.651)	($182.159)	$543.541	$391.964	($63.651)	($455.615)
Revenue								
LFD Revenue Estimate	1,590.833	1,661.583	1,744.911	1,826.637	3,761.508	3,252.416	3,571.548	319.132
Total Funds Available	$1,982.797	$1,799.868	$1,681.260	$1,644.478	$4,305.049	$3,644.380	$3,507.897	($136.483)
Disbursements								
General Appropriations - HB2	1,498.930	1,565.832	1,538.696	1,577.541	3,398.123	3,064.762	3,116.237	51.475
HB645 Language			118.083	118.083			236.166	236.166
Stimulus Approps. - HB645	53.069	57.052	-	-	-	110.121	-	(110.121)
Stimulus Transfers - HB645	79.247	38.209	-	-	-	117.456	-	(117.456)
Statutory Appropriations	179.451	181.379	190.112	197.425	422.348	360.830	387.537	26.707
Transfers	8.924	13.022	14.863	12.875	273.280	21.946	27.738	5.792
Other Appropriations	33.864	3.906	0.370	0.370	-	37.770	0.740	(37.030)
Feed Bill	2.929	10.608	2.589	10.438	-	13.537	13.027	(0.510)
Reversions	(5.193)	(6.489)	(1.294)	(2.589)	(164.732)	(11.682)	(3.883)	7.799
Total Disbursements	$1,851.221	$1,863.519	$1,863.419	$1,914.143	$3,929.019	$3,714.740	$3,777.562	$62.822
Fund Balance Adjustments	6.709	-	-	-	15.934	6.709	-	(6.709)
Ending Fund Balance Before Other Issues	$138.285	($63.651)	($182.159)	($269.665)	$391.964	($63.651)	($269.665)	($206.014)
Other Fiscal Issues*								
Executive Spending Proposals								
Spending Reductions	11.063	28.706	13.080	13.080	-	39.769	26.160	(13.609)
Revenue Transfers	0.271	0.417	-	-		0.688		(0.688)
Reductions Requiring Legislation	-	20.960	-	-	-	20.960	-	(20.960)
Tier 3 FMAP Change	5.405	10.242	-	-	-	15.647	-	(15.647)
Tier 3 Revenue Change	1.113	2.031	-	-	-	3.144	-	(3.144)
Total Executive Proposals	$17.852	$62.356	$13.080	$13.080	$0.000	$80.208	$26.160	($54.048)
Federal Clawback	6.331	2.032	-	-	-	8.363	-	(8.363)
Supplemental Appropriations	-	-	-	-	-	-	-	-
Current Service Level Impacts	-	-	(74.272)	(74.114)	-	-	(148.386)	(148.386)
Retirement Funding	-	-	(31.127)	(37.478)	-	-	(68.605)	(68.605)
Ending Fund Balance After Other Issues	$162.468	$24.920	($185.907)	($371.925)	$391.964	$24.920	($371.925)	($396.845)
Total Disbursements	$1,828.422	$1,801.579	$1,955.738	$2,012.655	$3,929.019	$3,630.001	$3,968.393	$338.392
Structural Balance Calculation			($223.907)	($199.098)				
Fiscal Policies Required to Achieve $100 Million Balance				($471.925)				

*Impacts under Other Fiscal Issues include revenue and expenditures and adjustments. Revenue increases are shown as a positive number, as they increase fund balance. Expenditure reductions are shown as a positive. Expenditure increases are shown as a negative as they decrease fund balances.

Other Fund Balance Issues

- Supplemental Appropriations
- Pending Litigation
- Otter Creek Coal Leases
- PPL Inc., River Bed Lease Payments
- Federal Enhanced FMAP Rate Extension

The $363 million or 18.6 percent cumulative fall in revenue from the peak in FY 2008 to the anticipated level in FY 2010 has significantly reduced available funds. Overall the deficit in structural balance or budget gap is approximately $200 million per year or roughly 10 percent of the total general fund expenditures.

Although this budget gap is a concern, it could have been worse. As seen in the revenue section, revenues have fallen substantially in the last two years. Montana revenues peaked at about $1.95 billion. The Legislature and Governor chose to not spend more than $1.8 billion in an ongoing manner. Without this spending restraint, the budget gap would have been significantly larger.

Even with revenue growth increasing at slightly higher than historical average rates in the next several years, the growth in revenues is not anticipated to catch the demand for services. Revenue increases from FY 2010 to FY 2013 average 4.8 percent per year. Expenditures are assumed to grow an average of 1.3 percent per year with present law level services and 3.3 percent per year continuing current level services and retirement funding.

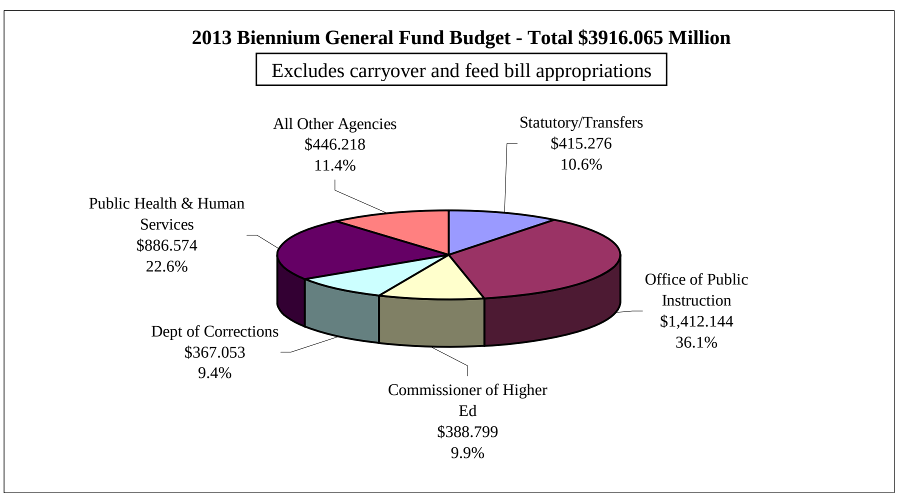
On November 15 of this year, the Governor is required to present a balanced budget for the next legislative session to consider. It would be reasonable to expect a recommendation of an ending fund balance of at least $100 million. With those parameters, it is anticipated that over $470 million of fiscal policy changes would need to be brought to the next legislative session.

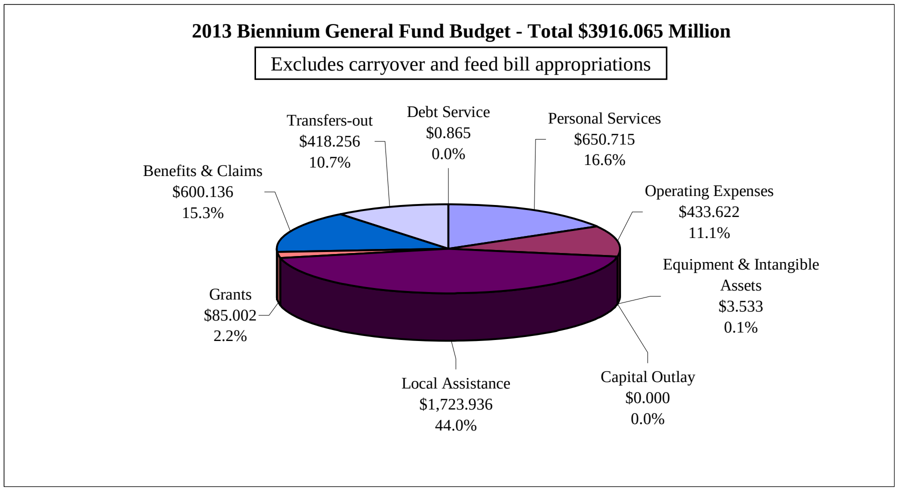
10 PERCENT OF PROJECTED 2013 BIENNIUM GENERAL FUND

As discussed earlier in this report, the budget gap facing the next legislature could be 10 percent of total general fund expenditures of state government. The purpose of this section is to provide a general view of what 10 percent of state expenditures by function and type of expenditure totals, and the types of choices the legislature will face. A number of caveats are attached:

- The following discussion does not suggest that budget reductions are the only options available to the legislature to close or eliminate the projected budget gap. The legislature will have a number of options for consideration
- Any totals shown are strictly for illustrative purposes. They are not meant to suggest options or targets for legislative consideration

The following charts show the projected allocation of general fund for current service levels in the 2013 biennium by function of state government and type of expenditure.





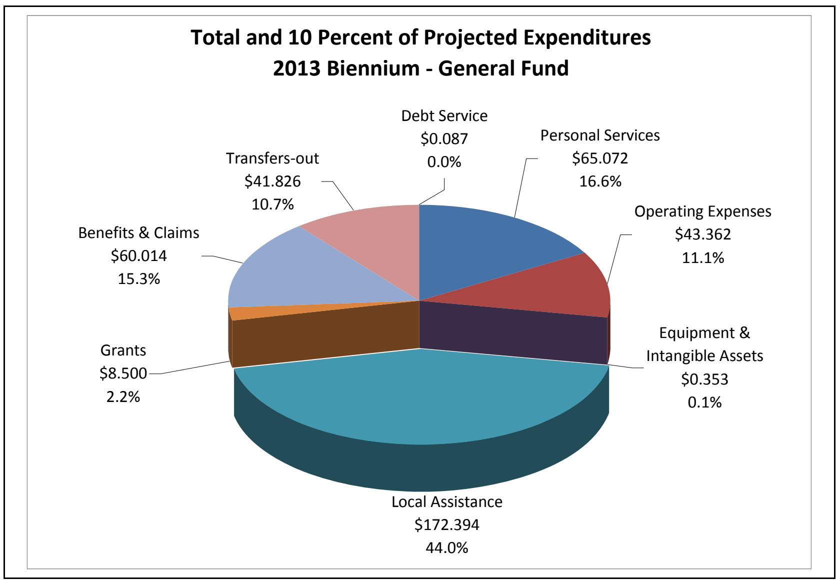
As shown, almost 80 percent of state expenditures are made in education, human services, and corrections, with all other agencies, consisting of such functions as the Legislative and Judicial Branches, the Department of Revenue, justice-related functions, cultural agencies, and others, comprising only 11.4 percent. As stated earlier, statutory appropriations at 10.6 percent of the total are dominated by payments to local governments for entitlement share and retirement costs.

The second chart shows that local assistance payments are almost half of total state expenditures, with benefit payments for services to low income persons at a further 15.3 percent of the total.

The following chart shows a 10 percent reduction by function of state government. The breakout sessions that follow will discuss in more detail the specifics within those areas to further illustrate the types of decisions the legislature will confront in the 2011 Legislative Session.

Total and 10 Percent of Projected General Fund Expenditures State Agencies and State & Local Partnerships (In Millions) 2013 Biennium	State Agencies	10% Amount	State & Local Partners	10% Amount
Major Function				
Office of Public Instruction	$24.281	$2.428	$1,387.863	$138.786
Commissioner of Higher Ed	371.104	37.110	17.695	1.770
Dept of Corrections	367.053	36.705	0.000	0.000
Public Health & Human Services	886.574	88.657	0.000	0.000
All Other Agencies	446.217	44.622	0.001	0.000
Statutory/Transfers				
Transfers	27.738	2.774	0.000	0.000
Entitlement Payments	0.000	0.000	211.761	21.176
Debt Service	33.525	3.353	0.000	0.000
Pension Payments	2.162	0.216	106.616	10.662
All Other	33.474	3.347	0.000	0.000
Total General Fund	**$2,192.128**	**$219.212**	**$1,723.936**	**$172.394**

Disbursement Level				
Personal Services	$650.715	$65.072	$0.000	$0.000
Operating Expenses	433.622	43.362	0.000	0.000
Equipment & Intangible Assets	3.533	0.353	0.000	0.000
Capital Outlay	0.000	0.000	0.000	0.000
Local Assistance	0.000	0.000	1,723.936	172.394
Grants	85.002	8.500	0.000	0.000
Benefits & Claims	600.136	60.014	0.000	0.000
Transfers-out	418.256	41.826	0.000	0.000
Debt Service	0.865	0.087	0.000	0.000
Total General Fund	**$2,192.129**	**$219.214**	**$1,723.936**	**$172.394**



APPENDIX A

MAJOR ECONOMIC ASSUMPTIONS

The LFD revenue staff has changed applicable economic assumptions to reflect the most current data available. These assumptions are based on the latest economic forecasts (January 2010) prepared by Global Insight (IHS) – a national economic forecasting company. Following are the major economic assumptions used by the LFD for the preparation of the revenue estimates contained in this document.

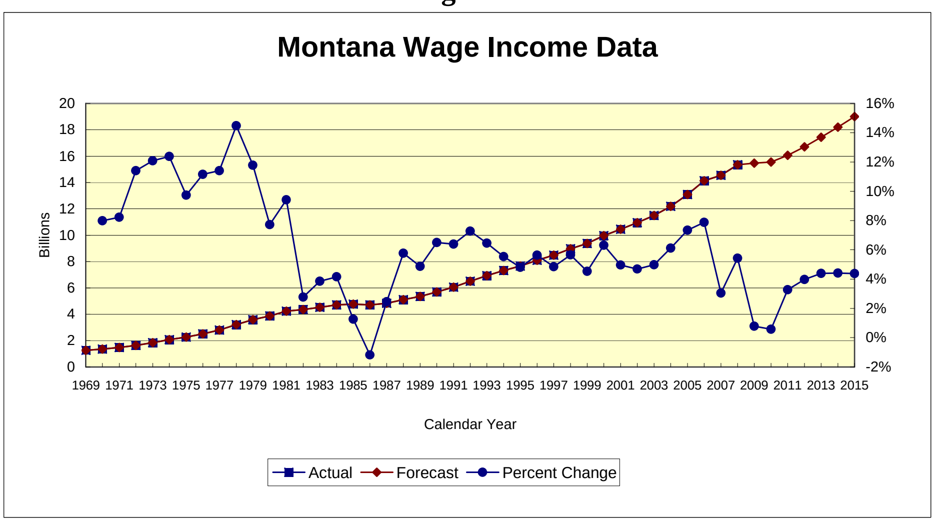
Economic Indicators

The four major economic assumptions used to forecast the state's general fund revenue for FY 2011 – FY 2013 are discussed in detail below. These four are: income, interest rates, corporation indicators, and energy prices.

Income

Montana's income, as measured by gross state product (GSP), is estimated to have been $36,186 million in 2009. GSP is projected to grow by 3 percent, in real terms, between 2009 and 2015. This rate of growth, as obtained from the most recent IHS projections, equals expectations for the growth of the gross national product over the same period. Service industries, including professional, business, educational, health, and financial services, are the principal source of income to Montana and currently account for 40 percent of GSP. Since 2000, service sectors have grown in relative importance, from 39 percent of GSP in 2000, and are expected to remain constant in the upcoming biennium, growing only as fast as the Montana economy as a whole. Other industrial groups important to the state's overall income are agriculture, mining, and construction - 17 percent GSP; and governmental activities - 15 percent GSP.

Figure 1



Income as related to state taxes is primarily driven by wages and salaries. The average annual growth in Montana wages and salaries has been 5.7 percent between 1991 and 2008. Wage growth exceeding this average occurred in the early nineties and again in the years of 2004-2006. In both these periods inflation was relatively high, i.e. greater than 2.5 percent, and employment growth was relatively high.

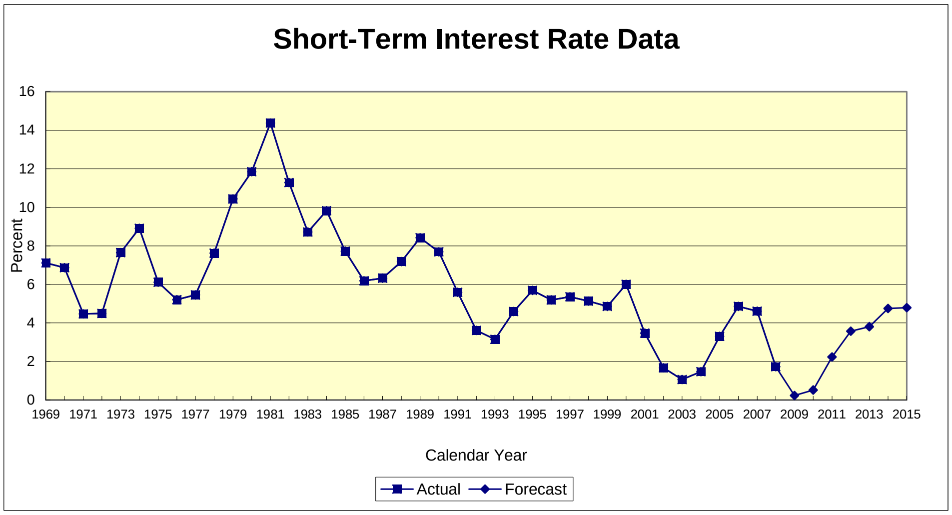
Wage and salary growth is expected to be reduced from previously high growth periods. In the most recent IHS Montana-specific forecast, wages for calendar 2008 though 2015 are expected to grow at an annual rate of 3.1 percent. Growth rates for calendar years 2009 and 2010 are expected to be less than 1 percent, increasing to 4.4 percent in calendar year 2015.

Interest Rates

Interest rates have been highly volatile over the past few years. To a large degree, interest rates are controlled by the Federal Open Market Committee (FOMC). The FOMC can control interest rates by targeting the federal funds rate (the rate banks charge each other for short-term loans to meet reserve requirements) for increases or decreases. With the events of September 11, 2001 and the recession that followed, FOMC reduced interest rates. In 2004, with fears of inflation, the FOMC reversed course, causing interest rates to rise. Beginning in 2007, the FOMC reduced interest rates in hopes of spurring economic growth and providing liquidity to the stalled financial sector.

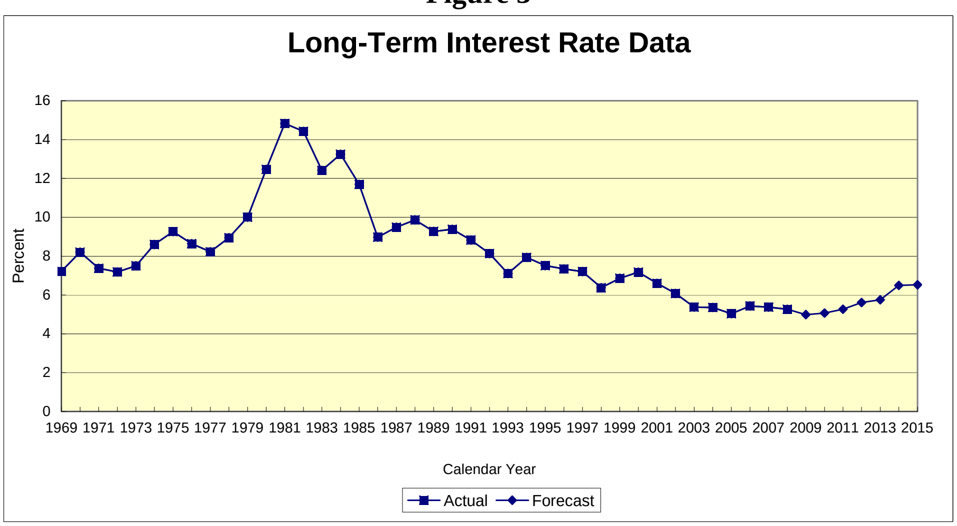
A large portion of Montana's revenues is derived from investment earnings from trust accounts and daily invested cash. Interest rates also affect the amount of investment income that is reported on individual income tax returns. As such, interest rates are a significant assumption when estimating future state revenues, and are fundamental in understanding the climate in which consumers and businesses are likely to make investments and large purchases. While low interest rates produce less revenue for Montana's trust and interest holdings, higher income tax earnings might be expected as construction and sales activities increase.

Figure 2



Two types of interest rates, long and short-term, are estimated and used in determining future revenues. Both rates are an average across a selection of investment instruments. The forecast rates are obtained from IHS. Interest rates have been at historically low levels since the beginning of the Great Recession and are expected to stay at very low levels through the next two years. As calculated by the LFD for forecasting purposes and shown in Figure 2, short-term interest rates are expected to be 0.5 percent in FY 2010, increasing to 4.8 percent by FY 2015. Long-term rates are expected to remain near 5.0 percent through FY 2011 and increase to 6.5 percent in FY 2015, as shown in Figure 3.

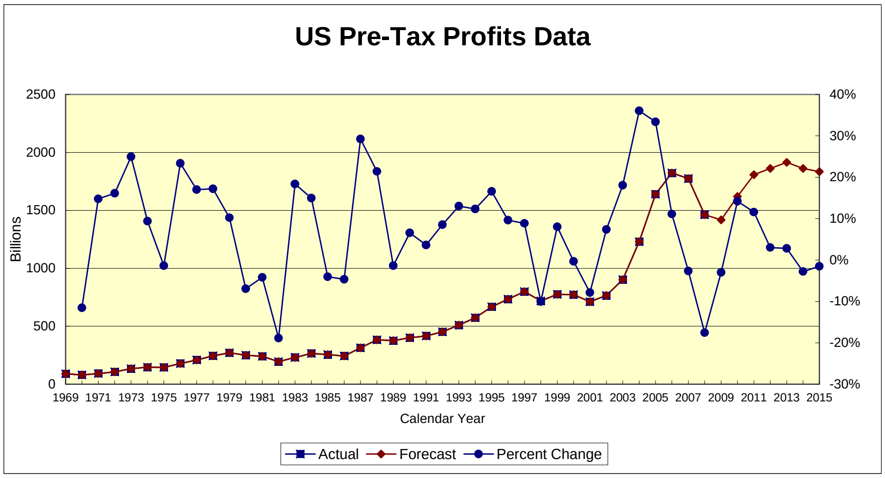
Figure 3



Corporation Indicators

The profitability of corporate America is an important factor in estimating revenues. Corporate profitability affects both corporation license tax and individual income tax estimates. When corporations are profitable nationally, there is an expectation that corporations will be profitable in Montana. Additionally, greater corporate profitability is largely responsible for the amount of dividends corporations pay to stockholders as well as the value of equity investments.

Figure 4

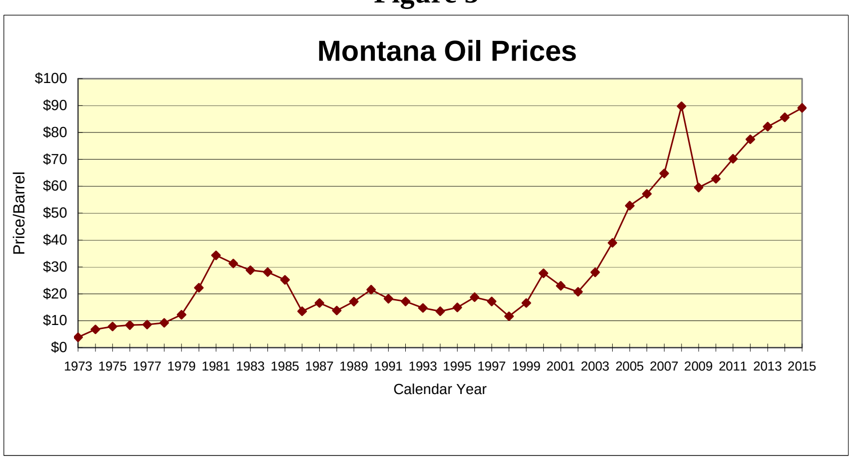


During the most recent years, the reduction of corporate profits has resulted in lower corporate license tax collections. According to IHS, between 1990 and 1997, US corporate pre-tax profits increased by an annual average of 10.3 percent. However, from 1997 through 2001, profits decreased by an average of 3.0 percent, the greatest decrease of 8.9 percent occurring in 1997. In 2004 and 2005, corporate profitability increased by 36.1 percent and 33.4 percent respectively. That trend has not continued, and with the nation in recession, corporate profits have declined substantially. In the most recent estimates provided by IHS, profits are expected to have declined by 3.0 percent in 2009 and rebound by 14.2 percent in 2010. As shown in Figure 4, corporate profits are expected to resume a slow rate of growth through 2013, followed by another period of negative growth through 2015.

Energy Prices

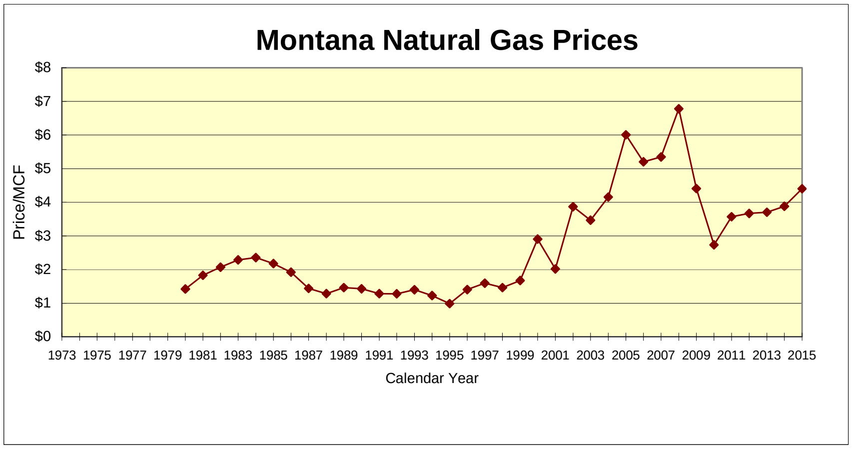
Energy prices have been volatile over the past decade. Changes in both supply and demand combine to cause dramatic price variations. For example, oil prices have varied between $12.87 per barrel in the fourth quarter of 1998 and $123.78 per barrel in the fourth quarter of 2008. In 2008, oil prices soared as demand outstripped supply, but as the world economy entered recession, prices began to decline. In recent months, the price of oil has increased and now is reported to be near $80.00 per barrel.

Figure 5



In the most recent IHS forecasts, West Texas Intermediate (WTI) oil prices are expected to average $61.76 in calendar 2009, and then increase to $68.13 in calendar 2010. WTI prices are expected to continue a slow rate of increase to $94.20 by 2015. While Montana wellhead prices are considerably lower than the WTI price, Montana prices are expected to follow a similar trend.

Figure 6

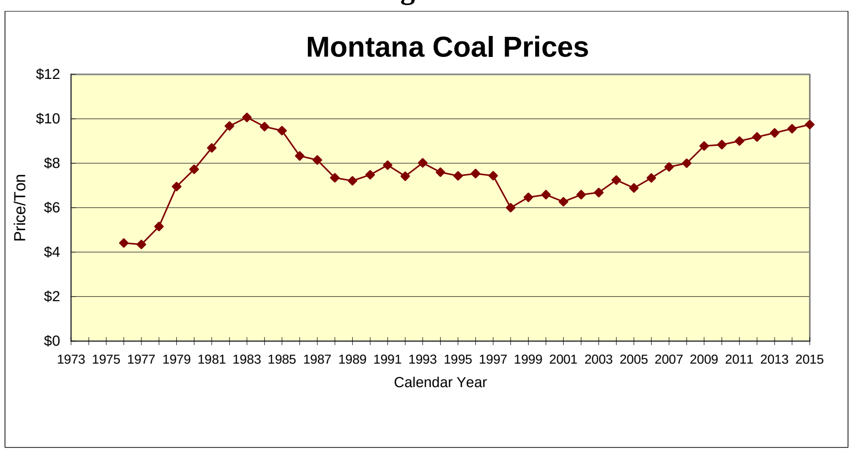


Natural gas prices at the wellhead in the US averaged $4.00 per MCF in calendar 2001 and increased to $6.22 by calendar 2007. IHS has determined that average wellhead natural gas prices fell to $3.56 in calendar 2009. Natural gas prices are not expected to increase to the highs experienced in 2007 ($7.86) in the foreseeable future, but prices are expected to resume a slow rate of increase and reach $5.92 in 2015. While Montana wellhead prices are usually lower than the US average wellhead price, Montana prices are expected to follow a similar trend.

Western U.S. coal production, which has grown steadily since 1970, is expected to continue to increase through 2015. Strong growth, combined with limited improvement in coal mining productivity, are expected to result in minemouth price increases of 1.8 percent annually from 2009 through 2015.

Between the years of 1998 and 2006, the Montana price for coal remained relatively constant. But according to recent tax return data, coal prices have started to rise. The Montana coal price is expected to increase slowly through 2015.

Figure 7



APPENDIX B

ESTIMATES OF MAJOR TAX TYPES

Individual Income Tax

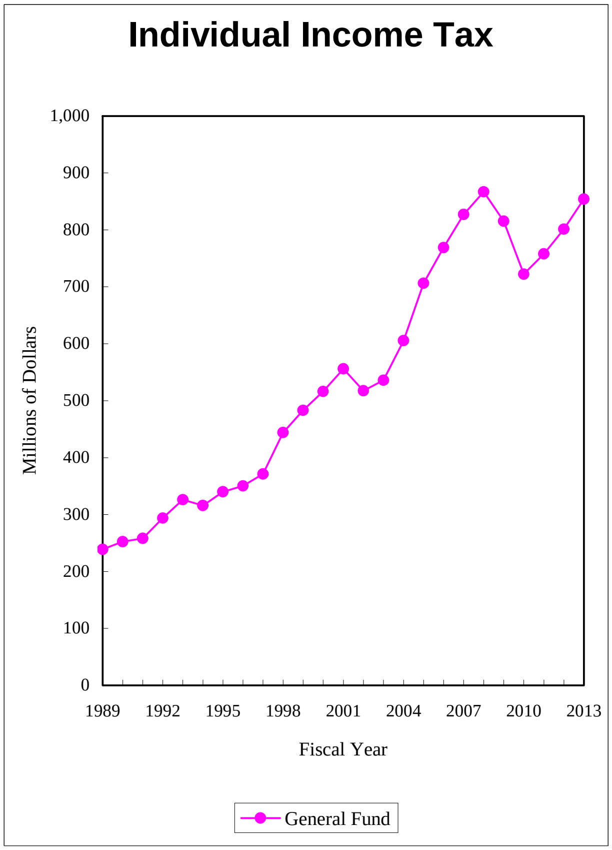
Background

The tax is levied against taxable income, which is defined as Montana personal income adjusted for exemptions and deductions. Once tax liability is determined, the amount of tax due is computed by subtracting allowable credits. Tax rates vary from 1.0 to 6.9 percent, depending on the level of taxable income. Tax brackets, personal exemption amounts, and the standard deduction are adjusted by the rate of inflation in each year. SB 407, enacted by the 2003 legislature, created a new capital gains income tax credit. As a result, the tax rate on capital gains income is less than the tax rate on ordinary income by 1 percent in tax years 2005 and 2006, and by 2 percent in tax year 2007 and beyond. This source has contributed the following percentages of total general fund revenue:

FY 2004 – 43.82%
FY 2005 – 46.13%
FY 2006 – 45.01%
FY 2007 – 45.04%
FY 2008 – 44.17%
FY 2009 – 45.1%

Revenue Forecast

	Fiscal Year	General Fund Collections Millions	GF Percent Change
A	1987	173.262483	Not App.
A	1988	219.241292	26.54%
A	1989	238.963596	9.00%
A	1990	252.230465	5.55%
A	1991	258.216424	2.37%
A	1992	293.564151	13.69%
A	1993	326.187735	11.11%
A	1994	315.677433	-3.22%
A	1995	339.939156	7.69%
A	1996	350.161013	3.01%
A	1997	371.275410	6.03%
A	1998	444.160729	19.63%
A	1999	483.031571	8.75%
A	2000	516.261912	6.88%
A	2001	556.014554	7.70%
A	2002	517.567691	-6.91%
A	2003	535.830664	3.53%
A	2004	605.348420	12.97%
A	2005	706.234579	16.67%
A	2006	768.922343	8.88%
A	2007	827.145498	7.57%
A	2008	866.659000	4.78%
A	2009	815.138193	-5.94%
F	2010	722.166077	-11.41%
F	2011	757.706858	4.92%
F	2012	801.320648	5.76%
F	2013	854.056658	6.58%



Individual income tax is expected to experience two years in a row of negative growth. Receipts in FY 2009 fell nearly 6 percent and are expected to fall another 11.4 percent in FY 2010. Positive growth of around 5.75 percent per year is expected between FY 2010 and FY 2013.

Montana wage growth in calendar 2009 was a negative 1.8 percent, and is expected by IHS to be 3 percent in FY 2010, 3.6 percent in FY 2011, and around 4.4 percent thereafter. Wage growth averaged 5.8 percent between calendar 1991 and calendar 2008.

Montana Employment is also expected by IHS to be below long-term historical trends though calendar 2013. Employment fell in calendar 2009 by 1.6 percent. It is expected to be flat in calendar 2010, grow 1.1 percent in calendar 2011 and average around 2.2 percent thereafter. The long-term average rate of growth in employment between 1991 and 2008 was 2.3 percent.

Montana interest income, dividend income, business income, and rents, royalties and partnership income are all expected to be down in calendar 2009, but resume growth in 2010 and thereafter.

Montana capital gains are forecast by the LFD to decline by 22.5 percent in calendar 2009, after declining nearly 36 percent in calendar 2008. Capital gains are forecast to be flat in calendar 2010, and then resume growth of 7.1 percent in calendar 2011, 6.4 percent in calendar 2012, and 5.5 percent in calendar 2013. The level of capital gains achieved in calendar 2007, a peak of nearly $2.1 billion, will not be achieved in the forecast horizon under consideration in this report.

Property Tax

Background

Montana law requires counties to levy a county equalization levy of 55 mills, a state equalization levy of 40 mills, and 6 mills for the university system against all taxable value in each county. A mill levy of 1.5 mills is also applied against all property in the five counties with a vocational technology (vo-tech) college. Taxable value is defined as the market value of statutorily defined property times a statutory tax rate. Property valued at market value includes personal property, utility property, railroad and airline property, and mineral net and gross proceeds. The assessed value of residential and commercial real estate is the market value phased in over the reappraisal cycle. Agricultural land and timberland are valued on a productivity basis and their values are also phased in over the reappraisal cycle. The most recent reappraisal cycle took effect January 1, 2009. Beginning January 1, 2009, a new reappraisal of residential and commercial property, agricultural land and timberland became available. The new reappraised values will be phased in over the next six years, FY 2010 through FY 2015. Unless changed by the legislature, the tax rates and exemptions will be constant at the levels for FY 2009.

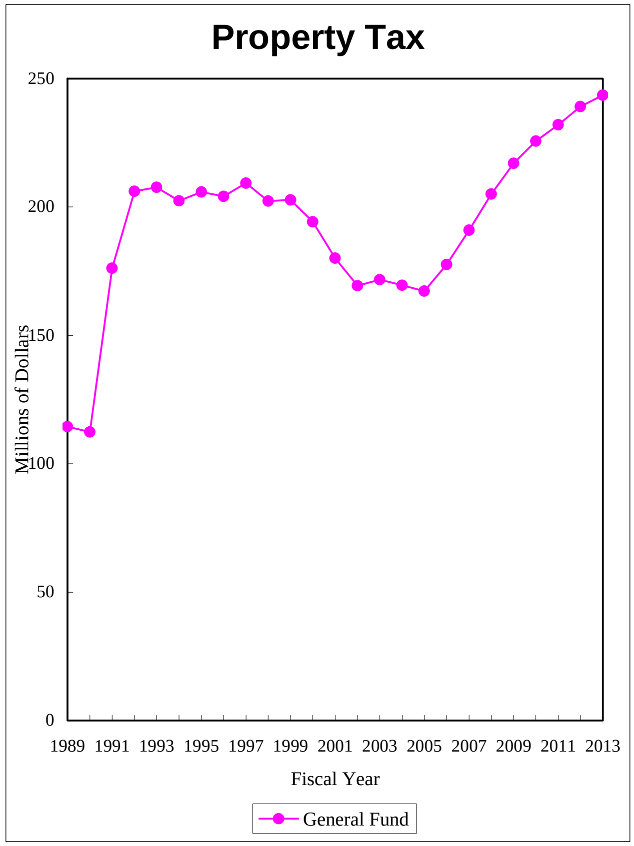
In addition to the tax on property, this revenue component includes collections from "non-levy" sources that are distributed on the basis of mills levied by taxing jurisdictions. These non-levy sources include the state share of coal gross proceeds taxes, federal forest revenues, and other smaller revenue sources.

This source also includes the state's share of protested taxes paid by centrally assessed companies. Should the state fail in defense of the taxation of these companies, the protested taxes must be returned to the taxpayer.

This source has contributed the following percentages of total general fund revenue:

FY 2004 – 12.27 %	FY 2007 – 10.74%
FY 2005 – 10.93%	FY 2008 – 11.53%
FY 2006 – 10.4%	FY 2009 – 12.0%

	Fiscal Year	General Fund Collections Millions	GF Percent Change
A	1987	128.225413	Not App.
A	1988	111.111138	-13.35%
A	1989	114.444609	3.00%
A	1990	112.374543	-1.81%
A	1991	176.154583	56.76%
A	1992	206.138029	17.02%
A	1993	207.646372	0.73%
A	1994	202.381945	-2.54%
A	1995	205.842671	1.71%
A	1996	204.082588	-0.86%
A	1997	209.284365	2.55%
A	1998	202.350380	-3.31%
A	1999	202.774979	0.21%
A	2000	194.196158	-4.23%
A	2001	180.050247	-7.28%
A	2002	169.339388	-5.95%
A	2003	171.679862	1.38%
A	2004	169.530994	-1.25%
A	2005	167.270350	-1.33%
A	2006	177.639199	6.20%
A	2007	190.981939	7.51%
A	2008	205.043751	7.36%
A	2009	217.042057	5.85%
F	2010	225.611140	3.95%
F	2011	232.042083	2.85%
F	2012	239.082160	3.03%
F	2013	243.529435	1.86%



The LFD expects property tax to grow slower in FY 2010 through FY 2013 than it has in the most recent 5-year period due to the slowing economy, less homebuilding, and a slow business climate. The average rate of growth in property tax between FY 2006 and FY 2009 was 6.9 percent annually. It is expected that the rate of growth between FY 2009 and FY 2012 will be close to 3 percent annually, and only 1.9 percent in FY 2013 because the formula for the distribution of federal forest receipts under the Secure Rural Schools and Communities Act is expected to revert to the old formula based on actual production. As a result, the 55 mills will receive nearly $3 million less in federal forest receipts in FY 2013 than currently.

Slow growth was revealed in fiscal 2010 taxable value data compared with the prior year. Taxable values for commercial real estate improvements fell 10.9 percent, although commercial land continued to grow. In addition, taxable value of business equipment rose only by 0.5 percent in FY 2010 compared to increases of near 5 percent in the previous 4 years. The only tax class with extraordinary growth is class 14 – wind generation – although its' taxable value is still small compared to other classes.

Corporation Income Tax

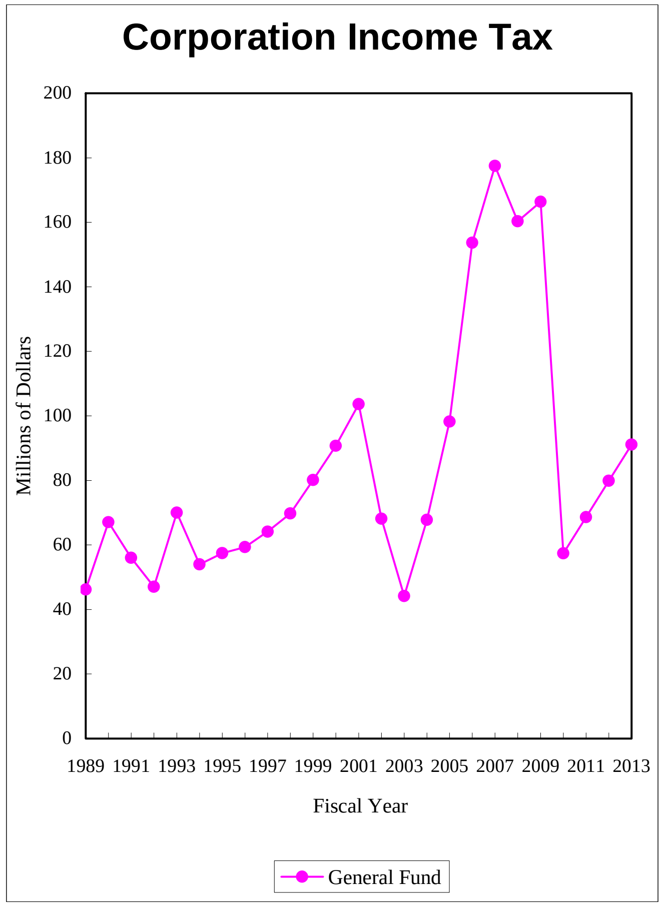
Background

The corporation income tax is a license fee levied against a corporation's net income earned in Montana. The corporation income tax is imposed on corporations that, for reasons of jurisdiction, are not taxable under a license tax. Factors that affect corporation income tax receipts include tax credits and the audit efforts by the Department of Revenue. As with individual income tax, all tax liability is adjusted for allowable credits. The tax rate is 6.75 percent, except for corporations making a "water's edge" election (see 15-31-322, MCA), who pay a 7.0 percent tax on their net income. This source has contributed the following percentages of total general fund revenue:

FY 2004 - 4.90%	FY 2007 - 9.67%
FY 2005 - 6.42%	FY 2008 - 8.17%
FY 2006 - 9.00%	FY 2009 - 9.20%

Revenue Forecast

	Fiscal Year	General Fund Collections Millions	GF Percent Change
A	1987	27.371125	Not App.
A	1988	37.584806	37.32%
A	1989	46.152627	22.80%
A	1990	67.087905	45.36%
A	1991	56.006784	-16.52%
A	1992	47.027797	-16.03%
A	1993	70.003987	48.86%
A	1994	53.996713	-22.87%
A	1995	57.425136	6.35%
A	1996	59.336677	3.33%
A	1997	64.078549	7.99%
A	1998	69.724680	8.81%
A	1999	80.142416	14.94%
A	2000	90.682672	13.15%
A	2001	103.670487	14.32%
A	2002	68.173253	-34.24%
A	2003	44.137518	-35.26%
A	2004	67.722940	53.44%
A	2005	98.213716	45.02%
A	2006	153.675068	56.47%
A	2007	177.503707	15.51%
A	2008	160.341786	-9.67%
A	2009	166.354514	3.75%
F	2010	57.392307	-65.50%
F	2011	68.630075	19.58%
F	2012	79.867842	16.37%
F	2013	91.105610	14.07%



Montana corporation tax collections lag the changes of national corporate profitability. National corporation profitability declined from a high of $1.6 billion in 2006 to $1.3 billion in 2008, and calculations of the Bureau of Economic Analysis do not indicate a significant change in 2009, as of the third quarter of 2009. Montana corporation tax collections started to decline in FY 2009, and have not shown any sign of improvement through the month of February. The collections through year to date February have not been so low since FY 2003, when the tax source exhibited the effects of the 2001 recession. The LFD expects that corporation tax collections will not improve through the remainder of 2010 and the result is a significant decline of 65.5 percent of tax collections, between FY 2009 and FY 2010. The projections further assume no growth in tax liability in FY 2011. However, FY 2011 does include a reduction in anticipated refunds which should coincide with a reduction in the amount of net operating losses carried back by corporations. Future collections are expected to grow at a rate similar to a one year lagged national corporation profits as projected by IHS, which mirrors the expected improvement of national corporation profitability.

Vehicle Tax

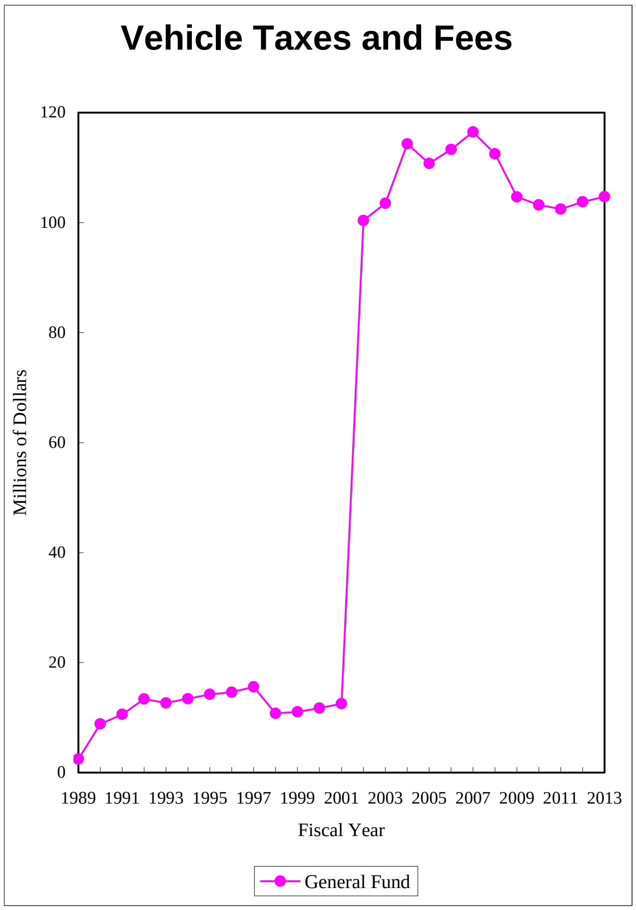
Background

Light vehicles, motorcycles and quadricycles, snowmobiles, buses, trucks, and truck tractors having a manufacturer's rated capacity of more than 1 ton, motor homes, and certain trailers and travel trailers are taxed under a fee schedule that varies by age and weight. The fee for light vehicles is $195 for ages between zero and four years, $65 for vehicles between five and ten years of age, and $6 for vehicles over ten years old. Owners of vehicles greater than ten years old may pay $87.50 (plus other applicable fees) for a permanent registration. The fee schedule for trucks varies by age and weight capacity. The fees-in-lieu-of-tax on motorcycles and quadricycles, trailers and travel trailers, snowmobiles, watercraft, off-highway vehicles are one-time payments, except upon change of ownership. SB 508 enacted by the 2009 Legislature earmarked revenue that had previously been deposited to the general ($4.0 million in the 2011 biennium) to fund a new online vehicle insurance verification system. This source has contributed the following percentages of total general fund revenue:

FY 2004 – 6.05% FY 2007 – 5.51%
FY 2005 – 5.23% FY 2008 – 5.26%
FY 2006 – 5.39% FY 2009 – 5.79%

Revenue Forecast

	Fiscal Year	General Fund Collections Millions	GF Percent Change
A	1987	2.608426	Not App.
A	1988	2.255149	-13.54%
A	1989	2.471472	9.59%
A	1990	8.869602	258.88%
A	1991	10.582218	19.31%
A	1992	13.378654	26.43%
A	1993	12.670105	-5.30%
A	1994	13.424539	5.95%
A	1995	14.238226	6.06%
A	1996	14.605759	2.58%
A	1997	15.588374	6.73%
A	1998	10.778306	-30.86%
A	1999	11.053035	2.55%
A	2000	11.715716	6.00%
A	2001	12.548251	7.11%
A	2002	100.398624	700.10%
A	2003	103.537563	3.13%
A	2004	114.330455	10.42%
A	2005	110.771948	-3.11%
A	2006	113.292384	2.28%
A	2007	116.471506	2.81%
A	2008	112.487931	-3.42%
A	2009	104.678282	-6.94%
F	2010	103.211470	-1.40%
F	2011	102.472839	-0.72%
F	2012	103.778354	1.27%
F	2013	104.713832	0.90%



Revenue from vehicle taxes and fees is expected to follow its continuing decline (from FY 2007) through FY 2011, but recovers each year of the 2013 biennium. Problems with the Department of Justice's MERLIN system and the lack of accurate data continue to be detrimental in estimating this source. With the assistance of department staff, a base for FY 2010 was estimated and adjusted by a growth rate of national vehicle stock. Adjustments were also made to reflect revenue decreases by SB 508 enacted by the 2009 Legislature to establish an online vehicle insurance verification system.

Oil and Natural Gas Production Tax

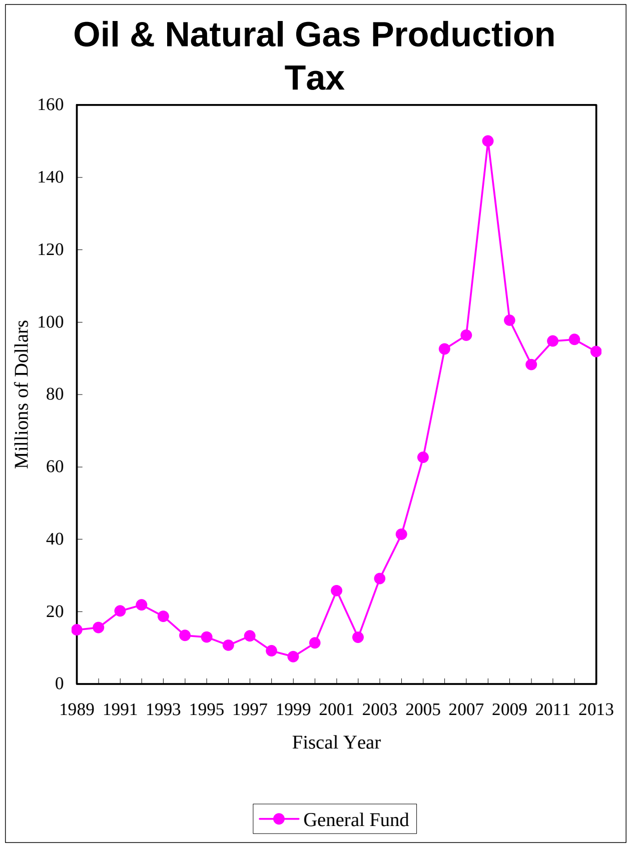
Background

The oil and natural gas production tax is imposed on the production of petroleum and natural gas in the state. Gross taxable value of oil and natural gas production is based on the type of well and type of production.

The oil and natural gas production tax has numerous tax rates depending on several factors. These factors include whether the oil or gas is produced from a stripper well, a stripper incentive well, from a well initially drilled before 1999 or after, from a well newly drilled within the last year or 18 months, and whether the interest being taxed is the working interest or the royalty interest. The Board of Oil and Gas Conservation imposes an additional privilege and license (P & L) tax on all oil and natural gas tax rates. Starting October 2006 as set by the Board, the P&L tax rate is 0.09 percent. Based on this rate, HB 758 enacted by the 2005 legislature allows an additional tax rate of 0.17 percent to generate revenue for local impacts for local governments. The two taxes may not exceed 0.3 percent. This source has contributed the following percentages of total general fund revenue:

FY 2004 – 2.99%	FY 2007 – 5.25%
FY 2005 – 4.09%	FY 2008 – 7.64%
FY 2006 – 5.42%	FY 2009 – 5.6%

	Fiscal Year	General Fund Collections Millions	GF Percent Change
A	1987	13.254877	Not App.
A	1988	17.975582	35.61%
A	1989	14.959251	-16.78%
A	1990	15.567426	4.07%
A	1991	20.163269	29.52%
A	1992	21.822893	8.23%
A	1993	18.676586	-14.42%
A	1994	13.403408	-28.23%
A	1995	12.963887	-3.28%
A	1996	10.665986	-17.73%
A	1997	13.283093	24.54%
A	1998	9.120152	-31.34%
A	1999	7.505617	-17.70%
A	2000	11.362741	51.39%
A	2001	25.791723	126.99%
A	2002	12.902439	-49.97%
A	2003	29.086038	125.43%
A	2004	41.323718	42.07%
A	2005	62.625939	51.55%
A	2006	92.562800	47.80%
A	2007	96.334992	4.08%
A	2008	149.993826	55.70%
A	2009	100.490971	-33.00%
F	2010	88.269324	-12.16%
F	2011	94.725580	7.31%
F	2012	95.173864	0.47%
F	2013	91.839762	-3.50%



The LFD expects oil and gas revenues to decline sharply in FY 2010 from FY 2009 due to reductions in production, even though prices are projected to increase throughout the year. Since FY 2009 was the second highest year of revenue collections due to an average yearly price of $59.55 per barrel, the decline seen in FY 2010 is accentuated. Revenues increase in FY 2011 and FY 2012 as increasing prices more than offset declining oil production and additional wells fade off the tax holiday. Revenues again decrease in FY 2013 as declining oil production outpaces increasing prices. Declining production is primarily the result of the Bakken oil formation in Montana beginning to show signs of increasing depletion. IHS prices are adjusted by historical ratios to derive Montana prices.

All Remaining General Fund Revenue

The remaining general fund revenue sources constitute 24.6 percent of the 2011 biennium total and 24.3 percent of the 2013 biennium total.

APPENDIX C

MAJOR GENERAL FUND EXPENDITURE ASSUMPTIONS BY FUNCTIONAL AREA

The following provides a more detailed discussion of all adjustments made for K-12 and higher education, human services, and corrections.

K-12 Education

By statute, the Superintendent of Public Instruction is required to determine an inflation factor for basic and per-ANB (average number belonging) entitlements each fiscal year based on the consumer price increase. The 2013 biennial estimates for K-12 education include the basic entitlement inflationary increases at 1.96 percent in FY 2012 and 1.7 percent in FY 2013. In addition, increases in the number of ANB are assumed to be 0.17 percent in FY 2010 and 0.76 percent in FY 2011. These inflationary and ANB increases in conjunction with replacing federal stimulus funding used to support increases of 1.0 percent in FY 2010 and 3.0 percent in FY 2011, result in estimates of an additional $24.7 million in general fund in FY 2012 and $38.0 million in FY 2013. The legislature funded an additional 2.0 percent in inflationary increases in FY 2010 as one-time-only. The estimates include restoring this funding at a cost of $11.2 in FY 2011 and $11.5 million in FY 2012.

In addition, school district block grant estimates include increases of 0.76 percent each fiscal year as required by law at a cost of $0.790 million in FY 2012 and $1.2 million in FY 2013. The at-risk component of BASE aid is estimated to be reinstated at the previous funding level of $5 million each year. The maintenance of effort requirement for special education funding previously supported from federal stimulus funds was included at $1.2 million annually. Vacancy savings were estimated at 4 percent rather than the 7 percent included in the 2011 biennium increasing general fund support by $0.278 million over the biennium.

Higher Education

Other present law cost adjustments for the Montana University System (MUS) funded by general fund include employee benefits and agency fixed cost adjustments at the educational units, educational agencies, and community colleges that reflect the same cost assumptions used in the budget projections for all other state agencies. These costs must be projected and added separately in the present law budget projection for the postsecondary education institutions because the state appropriation for these entities is to the Board of Regents, and then reallocated by the board to the educational institutions. The total amount of these types of adjustments is $1.9 million for the 2013 biennium.

The present law budget projection also includes $4.2 million general fund in the 2013 biennium for the Ground Water Investigations Program established by HB 52 and $75,000 general fund in the 2013 biennium for the Institutional Nurses Loan Assistance Program established by HB 224. Both of these bills were passed by the 61st Legislature. The appropriation, and the programs, in both bills are considered present law as there was no termination date contained in either bill.

The present law budget projection includes approximately $12.0 million general fund each year for costs that are not technically present law. However, the costs are included in the present law budget projection because they are costs that either would normally be funded from general fund (such as the 6-mill shortfall) or they are ongoing costs that are present law but were funded with one-time funding in HB 645, such as the tuition mitigation costs for the MUS educational units and community colleges.

The present law budget projection excludes the virtual academy as it is a new program that was funded with one-time funds in HB 645, though some ongoing costs could be expected.

Human Services (DPHHS)

The Department of Public Health and Human Services 2013 biennium general fund is estimated to be $209.0 million more than the 2011 biennium base budget due to these factors:

- $99.4 million to replace federal funds due to the temporary federal Medicaid match rate
- $64.8 million to continue one-time appropriations for provider rate increases ($28.5 million), backfill the one-time appropriations that fund existing services ($21.3 million), service expansions for Medicaid community services for the aged and disabled ($3.1 million), and other changes totaling less than $3.0 million each over the biennium
- $43.8 million for present law adjustments, including Medicaid eligibility and service utilization increases and foster care and subsidized adoption caseload growth

The general fund increase is net of a $20.6 million shift to state special revenue to pay Medicaid state matching requirements that would otherwise be funded from the general fund. The majority - $18.8 million - was set aside from collections related to one component of the enhanced federal Medicaid match rate change. Section 34 of HB 645 directed the set aside and that the state special revenue may be used only to fund 2013 biennium Medicaid costs, barring any amendment to 53-6-151, MCA by the 2011 Legislature. The second general fund offset - $1.8 million – is due to a legislative funding decision to offset part of the Medicaid provider rate increase to support healthcare for healthcare workers in FY 2011. The provider rate increase was initiated in January 2009 by the 2007 Legislature and continued by the 2009 Legislature.

The 2013 biennium general fund budget estimate does not include the potential cost of a Medicaid supplemental appropriation. As of February 2010, DPHHS projects a $10.0 million general fund cost overrun in FY 2010. The department expects to bring expenditures in line with FY 2010 appropriations, but has not indicated what actions it would take to do so. OBPP has indicated it will not “double count” the effect of proposed 17-7-140 spending reductions by applying those general fund savings to the potential cost over run.

DPHHS has already made reductions in operating and personal services costs, so it may not be possible to mitigate much of the potential cost over run without reductions in services or provider rates. States may not reduce eligibility for Medicaid services in order to continue to receive the temporary increase in the federal Medicaid match rate – worth over $175.0 million to Montana.

Corrections

The 2013 biennium growth in the adult offender population under the supervision of the Department of Corrections increases general fund expenditures by $24 million when compared to the 2011 biennium budget. The estimate includes an annual growth of 3.3 percent in the total average daily population with male secure care increasing 2 percent per year and adult probation and parole cases growing by 3 percent per year.

APPENDIX D

ANALYSIS OF PENSION SYSTEMS

INTRODUCTION

The purpose of this section is to provide a brief update on the status and condition of the unfunded actuarial liability (UAL) of the state's retirement systems. The market value of assets of Montana's retirement plans declined 22 percent during FY 2009, resulting in increased unfunded liabilities. Four of the nine pension plans had "negative" actuarial valuation reports as of the year ended June 30, 2009 and much of the loss in asset value has not yet been recognized in determining the unfunded actuarial liability. Both the TRS board and the PERS board have a policy that provides that if the board receives two consecutive "negative" reports, it has an obligation to recommend funding increases or other benefit changes to the legislature to address plan sustainability. Future legislatures will be faced with significant issues concerning the long-term health of the retirement systems. These fiscal issues are a part of the entire budget debate because the fiscal health of the retirement system is an important component of state and local government fiscal stability.

There are two parts to this discussion. The first focuses on the actuarial valuations of each plan as the tool that reports whether or not a retirement plan is actuarially sound. This is an important discussion because of its relevance to a constitutional requirement. The second part focuses on the "annual required contribution" (ARC) of the pension plans as estimated for future years, which are an indication of the long-term health of the pension plans. This analysis should not be taken as a recommendation for funding or a mandate for retirement plan changes.

ACTUARIAL VALUATIONS

Statute requires that an actuarial valuation be completed each year for each retirement plan. There are nine: 1) Teachers' Retirement System (TRS); 2) Public Employees' Retirement System (PERS - defined benefits retirement plan); 3) Sheriffs' Retirement System (SRS); 4) Game Wardens and Peace Officers' Retirement System (GWPORS); 5) Highway Patrol Officers' Retirement System (HPORS); 6) Municipal Police Officers' Retirement System (MPORS); 7) Firefighters' Unified Retirement System (FURS); 8) Judges' Retirement System (JRS); 9) Voluntary Firefighters' Compensation Act (VFCA)

The valuations, which examine each plan as of June 30 of each fiscal year, typically are completed by about October 1. Key data is summarized for the June 30, 2009 reports in Figure 8.

Figure 8

Pension Plan Unfunded Actuarial Liability
2009 Actuarial Valuations
(Dollars in Millions)

	TRS	PERS-DB	SRS	GWPORS	HPORS	MPORS	FURS	JRS	VFCA
2009 Valuation (as of 6/30/2009)									
Actuarial Accrued Liability (AAL)	$4,173.8	$4,792.8	$223.9	$92.2	$137.8	$345.3	$306.2	$41.8	$33.5
Actuarial Value of Assets (AVA)	2,762.2	4,002.2	200.7	81.2	99.6	214.3	209.8	61.9	27.2
Unfunded Actuarial Liability/(Surplus)	$1,411.6	$790.6	$23.2	$11.0	$38.2	$131.0	$96.4	-$20.1	$6.3
Funded Ratio (AVA/AAL)	66.2%	83.5%	89.6%	88.1%	72.3%	62.1%	68.5%	147.9%	81.2%
Years to Amortize Unfunded Liability	**Does not amortize**	**Does not amortize**	**Does not amortize**	**Does not amortize**	**21.5 yrs**	**22.1 yrs**	**12.7 yrs**	**0 years**	**6.9 yrs**
Net Statutory Funding Rate (EE & ER)	17.110%	14.030%	19.360%	19.560%	45.380%	52.780%	57.660%	32.810%	n/a
Normal Cost Rate	10.690%	12.160%	19.410%	18.530%	22.350%	26.820%	26.340%	25.900%	
Available for Amortization	6.420%	1.870%	-0.050%	1.030%	23.030%	25.960%	31.320%	6.910%	
Projected 30-yr Level Funding Rate	21.220%	16.420%	21.890%	20.250%	41.120%	48.330%	43.690%	-0.450%	
Projected Shortfall	4.110%	2.350%	2.530%	0.690%	-4.260%	-4.450%	-13.970%	-33.260%	
Market Value of Assets	$2,301.8	$2,998.6	$151.5	$61.9	$74.6	$162.1	$159.3	$46.6	$20.4
Ratio of Actuarial Value to Market Value	120.0%	133.5%	132.5%	131.2%	133.5%	132.2%	131.7%	132.8%	133.2%
Change in Market Value from 2008	-23.10%	-22.16%	-19.76%	-15.44%	-22.53%	-19.15%	-18.22%	-20.75%	-21.40%

The Constitution requires that the public retirement systems "be funded on an actuarially sound basis." Statute (19-2-409, MCA) defines "actuarially sound basis" as meaning that contributions to each retirement plan must be sufficient to pay the full actuarial cost of the plan. Statute goes on to provide that, for a defined benefit plan, "the full actuarial cost includes both the normal cost of providing benefits as they accrue in the future and the cost of amortizing unfunded liabilities over a scheduled period of no more than 30 years". Based upon the most recent valuations, these requirements are not being met for four retirement plans (the first four in the list).

Another important perspective, also shown in Figure 8, is the unfunded actuarial liability (UAL). As of June 30, 2009, the UAL for the 9 plans is nearly $2.5 billion. The last valuation that showed all pension plans "actuarially sound" was as of June 30, 2007. At that time the UAL was nearly $1.4 billion. This might suggest that to actuarially fund the plans 100 percent, $2.5 billion would be needed as a one-time payment, and to make the plans actuarially sound, about $1.1 billion would be needed.

Keep in mind that an actuarial valuation is a "snapshot" and does not reflect anything that has occurred since the valuation. It merely shows the fiscal condition of the plan at a single point in time and based upon a specified set of assumptions such as investment returns, wage growth, mortality, etc.

ANNUAL REQUIRED CONTRIBUTION

The annual valuation of a retirement system determines the annual required contribution (ARC). The ARC as prescribed by Governmental Accounting Standards Board (GASB) Statement No. 25, which pertains to the financial reporting of governmental retirement plans, is based upon the same parameters as defined by the statutes as described above (normal cost plus an amount to amortize the unfunded accrued liability over not more than 30 years). Therefore the ARC presented in an annual valuation report is also the contribution rate required to meet the statutory requirements. Due to recent economic experience, the current statutory rates are not sufficient to meet the requirements as defined by statute certain plans. As a result, additional contributions in excess of the statutory rate are required to fund the ARC.

Figure 9

Pension Plan Unfunded Liabilities Annual Required Contribution (ARC)
ARC Rate versus Current Statutory Rate

Fiscal Year	TRS	PERS	SRS	GWPORS	HPORS
Statutory Employer Rates					
2010	9.96%	7.17%	10.12%	9.00%	36.33%
2011	9.96%	7.17%	10.12%	9.00%	36.33%
2012	9.96%	7.17%	10.12%	9.00%	36.33%
2013	9.96%	7.17%	10.12%	9.00%	36.33%
2014	9.96%	7.17%	10.12%	9.00%	36.33%
2015	9.96%	7.17%	10.12%	9.00%	36.33%
Annual Required Contributions (ARC) Rate to Attain 30-Year Amortization					
2010	10.13%	10.93%	14.15%	10.36%	33.97%
2011	10.13%	13.01%	16.16%	11.38%	38.19%
2012	14.07%	14.38%	17.50%	12.04%	40.76%
2013	16.56%	14.53%	17.66%	12.02%	40.48%
2014	18.95%	14.68%	17.82%	12.02%	40.19%
2015	20.43%	14.85%	17.99%	12.00%	39.89%
Rate Shortage					
2010	0.17%	3.76%	4.04%	1.36%	n/a
2011	0.17%	5.84%	6.05%	2.38%	1.86%
2012	4.11%	7.21%	7.39%	3.04%	4.43%
2013	6.60%	7.36%	7.55%	3.02%	4.15%
2014	8.99%	7.51%	7.71%	3.02%	3.86%
2015	10.47%	7.68%	7.88%	3.00%	3.56%

Figure 9 shows the difference between the statutory contribution rate and the estimated ARC. The difference or shortage would translate to the increase in contributions needed to ensure that the unfunded liabilities of the pension plans can be amortized within 30 years. Please note that the ARC percentages for FY 2012 through FY 2015 are estimates and will change as soon as the July 1, 2010 valuations are completed.

When the ARC rate is applied to the projected wage data of state and local government employees and teachers for FY 2012 and FY 2013, the estimated state general fund impact is $31 million for FY 2012 and $37 million for FY 2013.

This calculation also includes a potential adjustment to the contribution rates of the university system's Optional Retirement Plan (ORP), specifically the portion that the employer must pay to TRS to pay down unfunded liabilities (future costs) resulting from TRS members being in the ORP plan rather that the TRS plan. A preliminary estimate suggests that 3.8 percent be added to the current supplemental rate of 4.72 percent. There is a study underway to determine what the additional contribution needs to be.

What the Data Shows

Using the estimated ARC rates discussed above, the total impact is $304 million for the 2013 biennium, including impact on the state general fund, other state funds (state special, federal, etc.), local governments, and schools. Figure 10 shows the potential impact for the next two biennia.

The analysis assumes that local governments and schools would be responsible for their costs except where the guaranteed tax base (GTB) comes into play. GTB costs are shown in the figure as part of the state general fund costs. In addition, the general fund estimated costs include estimates of the portion of university system current unrestricted funds that would come from the general fund. It also includes a portion of the proprietary funds that translate to general funds when agencies are billed for internal service fund services such as information technology services. The estimated cost to the general fund in the 2013 biennium is $68 million. The cost to other state funds would be $94 million.

Figure 10

Potential Pension Cost Increases
FY 2012 - FY 2015 (Dollars in Millions)

	FY 2012	FY 2013	FY 2014	FY 2015
State Costs				
General Fund	$31	$37	$44	$49
Other Funds	44	50	55	60
Local Schools	28	42	57	67
Local Government	35	37	39	42
	$138	$166	$195	$219

Local Schools

Each county has a county retirement account for employees employed by school districts. This account collects revenue to pay for the employer contributions to the TRS and PERS on behalf of school employees. It also collects revenue to pay for the Social Security, Medicare and unemployment insurance on behalf of school district employees.

Each school district reports its retirement, Social Security, Medicare and unemployment insurance requirements to the county superintendent. The county superintendent sums these requirements for districts within the county. The state by law pays a portion of the contribution and the counties pay the remainder. For instance, for TRS, the state contributions into TRS for FY 2010 and FY 2011 are 2.38 percent of wages plus .11 percent of wages for a total of 2.49 percent. The counties pay 7.47 percent of wages. The figure shows that the cost to schools overall would be $70 million for the 2013 biennium and $124 million in the 2015 biennium. By FY 2015, when the cost would be $67 million, about 3.5 percent of total school budgets (about _??_ mills statewide).

The county has three main sources of revenue to pay for the increased retirement costs: Non-levy revenue (such as oil and gas revenue, coal gross proceeds, interest earnings), property taxes, and, if eligible, state GTB payments. A county is eligible for state GTB payments if its taxable value per pupil is below 121 percent of the statewide average taxable value per pupil.

Once a county has received the revenue to pay for the required contributions for the school districts within its boundary, it sends the revenue to each school district that then pays the contributions, as well as social security, Medicare and unemployment insurance.

If local contribution rates increase and the state does not increase its share, then the retirement revenue requirements for counties will also increase. Some counties may have enough revenue from non-levy sources so that property taxes and state GTB will not increase. In the absence of sufficient non-levy revenue, when local contribution rates increase, a county must raise the additional local revenue through property taxes and GTB.

Local Government

MCA 15-10-420 limits the increase from year to year of a local government's revenue from property taxes to one-half the rate of inflation averaged over the prior three years without a vote. This applies to county governments and city governments, but not to school districts, and the county retirement account discussed above is considered to be exempt from 15-10-420.

The result from applying the potential ARC rates as future contribution rates to local government jurisdictions are shown in Figure 10 for FY 2012 through FY 2015. The analysis shows a cost to local government of $72 million for the 2013 biennium, which might result in property tax increases if room exists under the limit, or the reduction of current service levels in order for counties or municipalities to cover the increased costs. The estimated $72 million is about 2 to 3 percent of total county and municipality 2-year budgets statewide. For the 2015 biennium, the estimated cost of $81 million would also fall into the 2 to 3 percent range

FURTHER RISKS

As previously mentioned, the analysis is based upon the pension plan actuarial valuations as of June 30, 2009. Although the equity markets have made big gains since that time, they continue to experience volatility. What the next valuations will show at the end of the current fiscal year is unknown. The expectation is that at least four pension plans will still not be actuarially sound.

Another factor to be aware of is that the TRS board and the PERS board have "experience studies" underway which look at the track record of assumption used in the actuarial valuations. It is possible that the results will show that assumptions need to be changed in some instances. If as an example, the assumption for investment returns is lowered for the next valuation, it would adversely impact the unfunded actuarial liabilities.