RISK ASSESSMENT REPORT

A Report Prepared for the

Legislative Finance Committee

By

Legislative Fiscal Division

October 4, 2010

Legislative Fiscal Division

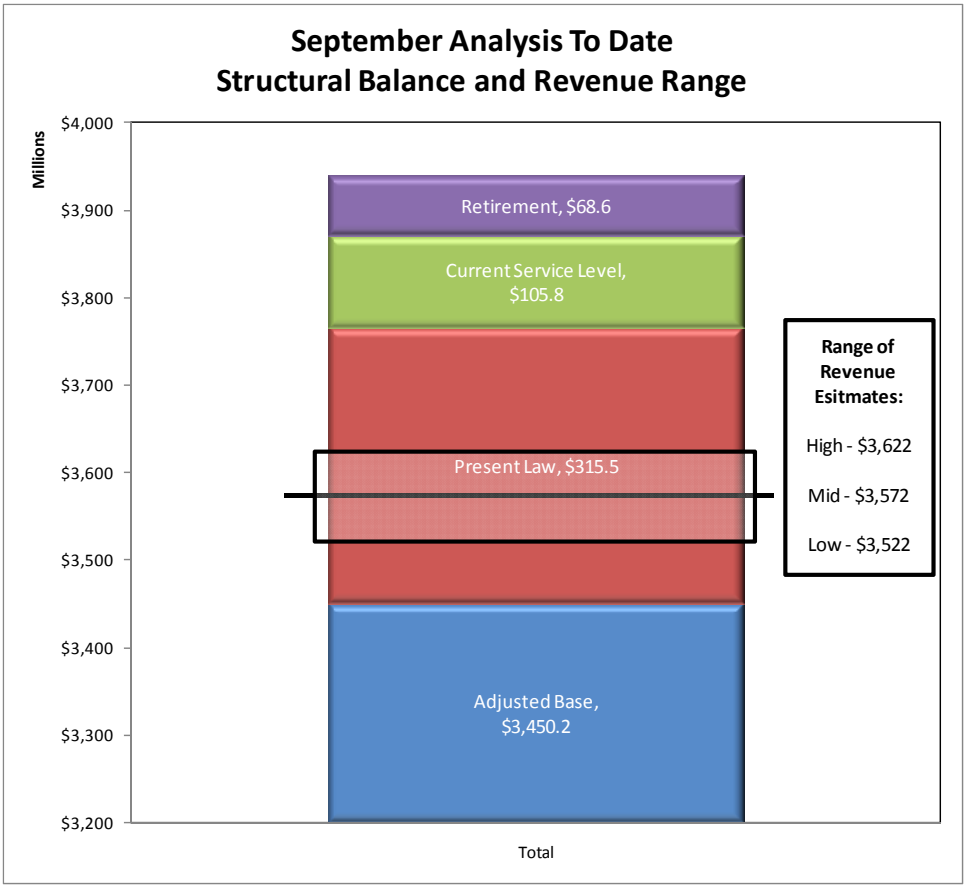
www.leg.mt.gov/css/fiscal

EXECUTIVE SUMMARY

The following report updates the analysis the Legislative Fiscal Division presented in March on the "big picture" of the overall state financial and budget condition for the 2013 biennium. In March, the analysis demonstrated a structural budget gap of approximately $400 million. This gap included different categories of costs: adjusted base, present law, the level of current services provided, and the cost to pay the actuarial required rate for the retirement systems.

The analysis in this report updates the March work and continues these categories of cost. Given changes in forecasted costs and preliminary budget assumptions by the Governor's Office of Budget and Program Planning (OBPP) this gap appears to have narrowed. If all categories of cost continue to be measured, the structural budget gap is now approximately $368 million in comparison to the $400 million in March.

In addition, the anticipated ending fund balance has improved dramatically. The lowest estimate in March before any subsequent improvements was as low as negative $63 million. Today, an ending fund balance exceeding $200 million appears likely. Please see page 16 for more details.



Revenue trends are mixed. Personal income tax collection estimates have weakened and corporation tax collection estimates have strengthened. Other revenue sources have also trended both up and down. At this point in time, with significant additional data coming in November, there is not enough information to adjust the 2013 biennium revenue estimates. Given the level of certainty of the data at this point in time, the Legislative Fiscal Division is estimating that the biennial revenues will be within $50 million of the estimates provided in February and March.

The report concludes with possible solutions and the risks associated with those options. The key choices evaluated include:

- Ending fund balance – a portion of the "cash" in the bank could be used to offset expenditure reductions
- Retirement $68.6 million – the cost to actuarially fund the pension systems could be delayed until the next biennium
- Current Service Level $105.8 million – the health services, provider rates and school funding items that comprise most of these costs could be eliminated
- Four Percent Personal Services Reductions $19.8 million – the legislature could accept the OBPP four percent reduction in personal services
- Caseloads – assumptions on caseloads could be reduced
- Five Percent plans up to $100 million – the legislature could choose to adopt some of the items included in the five percent reduction plans submitted by the agencies
- Reference Book - the legislature could choose to adopt some of the items in the Reference book developed by the Legislative Finance Committee subcommittees and the Legislative Fiscal Division

Please refer to page 18 for a brief description of the risks associated with each of these items.

THE REPORT

The following report gives the background and transition from the original March expenditure analysis to the current expenditure analysis. In order to break down the changes into understandable adjustments, the March expenditures are first re-categorized based on the final FY 2010 base year expenditures and agency preliminary budget submissions per OBPP instructions. The section that follows then updates the estimates given current cost trends.

An overview of revenue trends, fund balance adjustments, and the risks associated with the choices before the legislature in the next biennium finish out the analysis.

MARCH AND MARCH RE-CATEGORIZED

In March the Legislative Fiscal Division projected costs using a number of assumptions. These expenditures were defined expenses in one of four categories: 1) adjusted base, 2) present law, 3) current service level, and 4) retirement. A number of developments subsequent to the writing of that report have affected the categories. In order to clearly articulate and compare budgets from this point forward, a re-categorization of the original March allocations is needed. These changes update previous assumptions and allow for comparison with the agency budget submissions and future versions of the budget. In total the change is only $3 million, but changes within budget categories are more significant. The largest single adjustment is the receipt of the Otter Creek coal bonus payment, which reduced the adjusted base and increased the present law level by $81 million.

The following shows the assumptions, by category, made in the original March projections. It is followed by the March re-categorization, along with a detailed discussion of all assumptions used and the difference from the original March calculations.

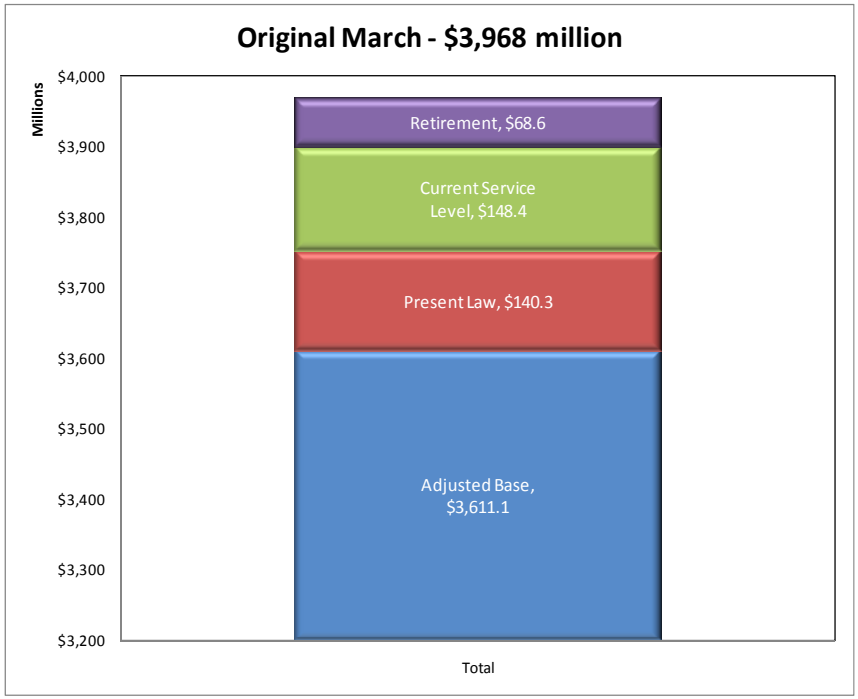
Definition of Expenditure Categories

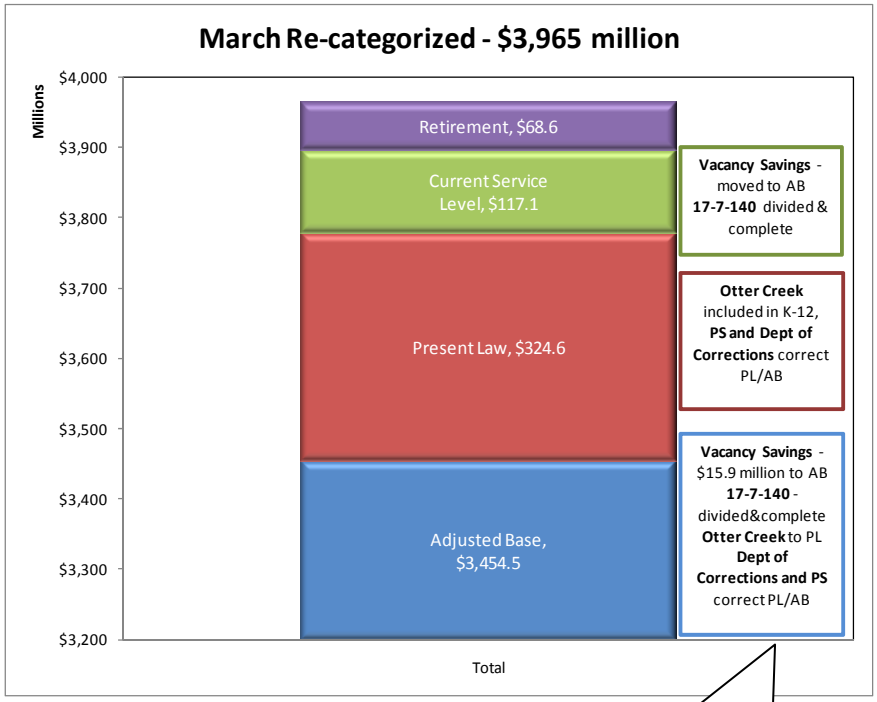
The total of all projected costs are estimated to derive the current level of service. "Current level of service" is defined as that level of funding necessary to maintain the services provided in FY 2011. It consists of three components:

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. They are composed of two parts:
    a. The adjusted base, which is actual base year expenditures with various adjustments; and
    b. Present law adjustments, which are changes to the adjusted base necessary to maintain ongoing services
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. These expenditures are called "current service level" for purposes of this report.
3. Similar to current service level, employer contributions necessary to achieve 30 year actuarial soundness in the state and teacher's retirement systems are included in the calculations under "Retirement" as they maintain the current level of benefits received by employees.

Note that all numbers are general fund biennial unless stated otherwise.

Comparison of the Original March and Re-categorized





These items summarize the changes made between the original March original assumptions and March Re-categorized. More details of these changes can be found on the next several pages.

MARCH RE-CATEGORIZED

The following discusses all assumptions used in the March re-categorization and all changes from the original calculations. As mentioned above, the total change is about $3 million, but a number of categorical changes were made.

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.

ADJUSTED BASE ASSUMPTIONS

- Removal of OTO expenditures, including all HB 645 (federal stimulus) funds - $272.4 million (including $227.6 million in HB 645)
- Minor inflation for:
  - Increases in personal services benefits, including unemployment insurance and workers compensation
  - Certain fixed costs such as tort claims and information technology
  - No other inflation except for statutorily required additions in K-12 education (see below)
- The cost of increasing the FY 2010 level of health insurance costs to the level approved by the 2009 Legislature for calendar year 2011 and beyond - $3.7 million
- 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
- Any ongoing savings due to the OBPP recommendations to the Governor under 17-7-140, MCA – $29.6 million. An error was found in the original total of $26 million, which is corrected in the March Redefined. In addition, these costs are now split between Adjusted Base ($14.3 million) and Current Service Level ($15.3 million)
- Fire costs are assumed to be funded with the Governor's emergency fund ($16.5 million for all disasters)
- The workers' compensation "old fund" general fund transfer - $16.5 million
- Otter Creek – The coal bonus payment in the school guarantee account reduced the actual general fund expenditures in FY 2010 and thus reduced the adjusted base and increased the amount of present law adjustment needed to fulfill the statutory requirements. This adjustment was not included in the original March projections
- A change in allocation between present law and the adjusted base in the Department of Corrections base budget – $6.5 million
- Movement of personal services typically removed from the base in the adjusted base budgeting process to present law adjustment - $11.5 million

- An increase to return to 4 percent vacancy savings from the 7 percent adopted by the 2009 Legislature – $15.9 million for the biennium. Note that the executive has included this amount in the adjusted base. This adjustment had been made in the current service level in the March report.

PRESENT LAW BASE - CASELOAD AND OTHER INCREASES

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

- Human services – Medicaid, foster care, and subsidized adoption - $43.8 million. This projection was increased in the September calculation (page 9)
- Corrections – Overall populations increases of about 3.3 percent - $24.0 million. The projection assumes the department will be able to maintain a ratio of about 80 percent community to 20 percent secure care supervision. This projection was lowered in the September calculation (page 9)
- 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. The estimate of total general fund costs to support K-12 was lowered in the updated September projections (page 9)

CURRENT SERVICES LEVEL

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

- K-12 Education – Funding of at-risk payments, continuance of the one-time only (OTO) 2 percent entitlement components, and special education - $35.5 million
- Department of Public Health and Human Services (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
- An increase to return to 4 percent vacancy savings from the 7 percent enacted by the 2009 Legislature was moved to the adjusted base in the March Re-categorized from this category

PENSION FUNDS

Funds were included to bring the various pensions funds to a 30-year actuarial soundness using only employer contribution increases. These costs assume that the legislature funds the actuarial cost to maintain pension benefits through the next biennium without reducing employee benefits.

- 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

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
- Inflationary adjustments for provider rates, rents, food, fuel, or other contracts
- Water compact distributions to the Blackfeet or Gros Ventre tribes
- Supplemental appropriations
- New proposals

CHANGES IN THE SEPTEMBER CALCULATION

Adjusted Base Assumptions

The adjusted base amounts are the September 1 agency submitted adjusted base. The OBPP will change funding and other assumptions affecting the adjusted base for the final Governor's budget, but the core elements are in place. The following assumptions show the difference between those used for the March Big Picture Report and the revised assumptions shown above.

- Deflation was added for two key components:
  - Motor pool rates were decreased approximately 21% or $600,000
  - Natural gas rates were reduced by 35.45% or approximately $800,000
- Fixed costs are statewide services such as insurance, Capitol Complex rent, accounting and human resource system costs, and central information systems costs. In total these costs have been budgeted in all funds to be $3.8 million less than the 2011 biennium. In addition, the allocation of these costs is anticipated to shift away from general fund expenditures to other funds. Given the method of budgeting, the actual general fund savings is not available. It is estimated that the savings from these actions will save approximately $1 million per year general fund.
- Non-budgeted transfers increased $4.0 million for the Montana State Fund, transfers to the Old Fund due to an increase in the estimated actuarial cost to fund claims.
- Further staff analysis is needed to describe the remaining $3.2 million in reductions in the adjusted base and will be included in the December budget analysis.

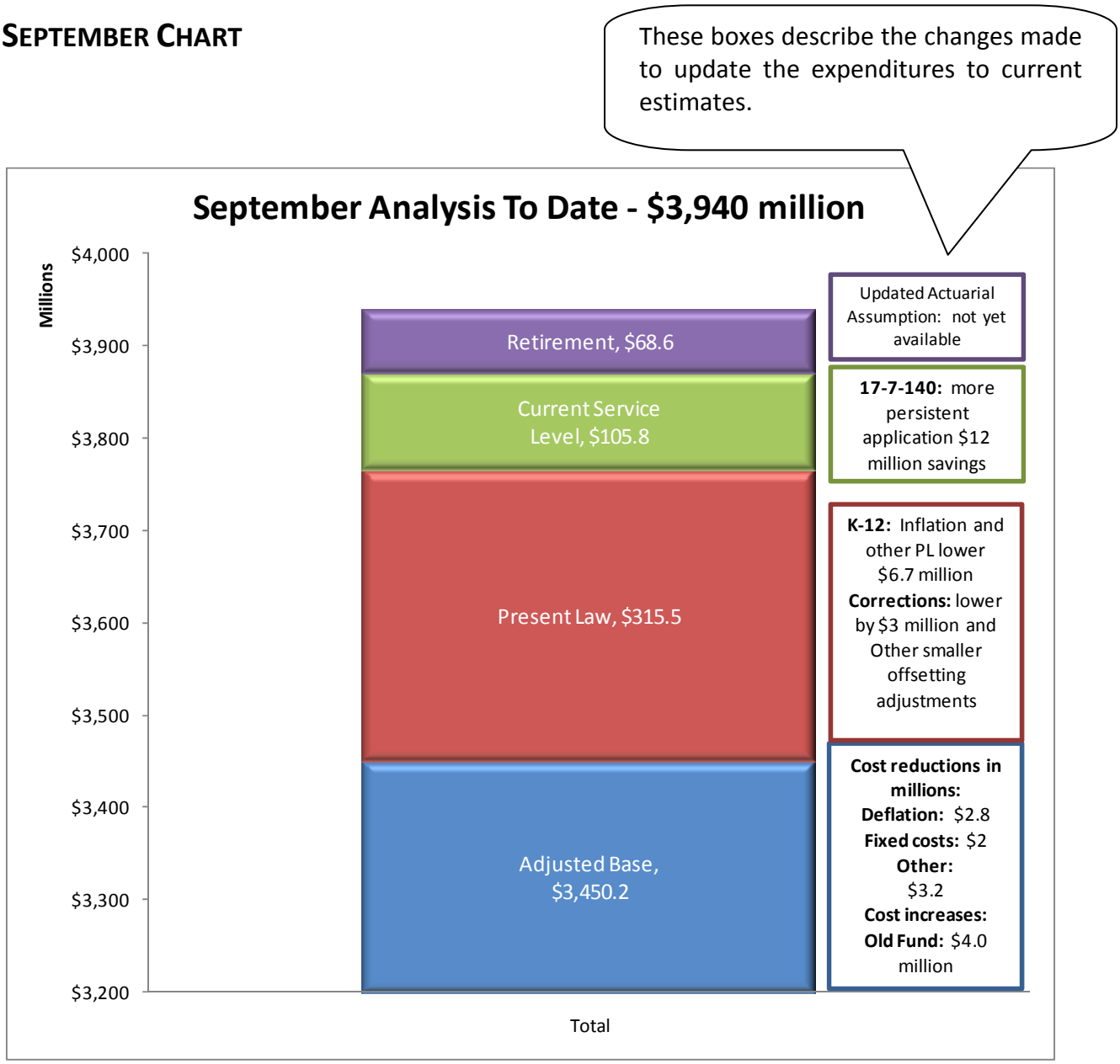
Present Law Adjustments/Caseload Increases

The Legislative Fiscal Division updated cost projections from the March 2010 estimates in five primary areas. In this analysis, most present law adjustments have not changed. Please see page 19 for changes in the agency submitted caseload estimates.

- Correctional population growth was lowered from $24.0 million to $20.8 million over the biennium as a result of updated FY 2010 growth figures that were less than assumed in the March report. A reduction in projected growth in male community and probation and parole placements were the primary drivers of the lower projected costs
- Judicial Branch projected costs were increased by $0.1 million over the biennium to reflect updated salary survey information used to determine 2013 biennium compensation for elected officials
- K-12 education was reduced by $5.9 million over the biennium since the March report due to slightly higher projected student (ANB) numbers, a reduction in the calculation of inflation, and lower guarantee account income
- Montana University System projected cost increases of $3.0 million reflect a technical adjustment to properly estimate statewide present law personal services and fixed cost increases for the educational units and agencies
- Human services (primarily Medicaid) costs were maintained at the March level, with the exception of adjustments due to an increase in foster care and subsidized adoption of

$2.4 million. In addition, general fund is added due to a reduction in the federal Medicaid match rate (FMAP rate) Medicare Part D clawback payments from the enhanced level ($1.4 million), to properly account for the biennial $22 million one-time only (OTO) reduction required by the 2009 Legislature ($1.3 million), and a reduction in the Medicaid reserve state special revenue available to lower general fund costs ($1.8 million)

SEPTEMBER CHART



CURRENT SERVICES LEVEL

The Legislative Fiscal Division assumed $15.3 million in reductions to the current service level through reductions in decision packages as a result of the Governor directing agencies to reduce expenditures under MCA 17-7-140 in April 2010. The decision packages submitted by the agencies appear to more persistently implement these reductions in the 2013 biennium budget request. About $12 million more reductions were included in the agency submitted decision packages than the Legislative Fiscal Division assumed in March.

PENSION FUNDS

An updated actuarial evaluation has been issued for the Teachers' Retirement System (TRS) but only preliminary numbers are available for pension plans administered by the Public Employees' Retirement System (PERS). Data not available at this time includes the annual required contribution for each PERS plan, so a revised estimate of cost cannot be developed at this time. However, from available data, it appears that the March estimate of retirement costs is still reasonable and, if anything, it might decrease slightly. This would be due to the following:

- By board policy, TRS recognized a significant portion of their FY 2009 losses in determining the actuarial value of assets in the 2009 valuation so that the 2010 valuation recognized a lesser amount than would otherwise have been recognized. That, along with the investment gains of FY 2010, results in a lesser required annual contribution in the near term as compared to 2009 estimates.
- On the other hand, PERS lowered its assumed investment returns assumption from 8 percent to 7.75 percent in addition to having to recognize one-fourth of its 2009 losses, likely resulting in a significantly higher unfunded liability and a higher annual required contribution.

REVENUE ASSUMPTIONS

INTRODUCTION TO ECONOMIC CONDITIONS

The general outlook for the US and Montana's economy for the next three years is for a slow and gradual recovery from the "Great Recession". Although Montana's economy is affected by commodity prices for oil, natural gas, coal, metals, and agricultural products, many other economic factors are affected by national conditions beyond the state's control. Interest rates, global commodity demand, equity gains and losses, 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 drivers are used to forecast revenue for the fiscal period 2011 – 2013.

Actual revenue collections for FY 2009 and 2010 declined from their peak levels reached in FY 2008 and are not expected to reach that level again until FY 2015. However, estimated receipts beginning in FY 2011 are expected to show signs of recovery but at a slow modest rate. If a "double dip" recession occurs, the revenue outlook would be worse but would depend on the length and severity of the second recession. The economic conditions during the last two years have changed rapidly as significant issues have unfolded during this time.

KEY RISKS TO ECONOMIC ASSUMPTIONS

Income – As the unemployment rate increases or stabilizes, Montana wage and salary income may decline or increase only modestly. Since wage and salary income is the largest component of income tax revenue (Montana's largest general fund revenue source), even a minimal decline could have a negative impact on general fund revenue.

Interest Rates – The federal funds rate set by the Federal Reserve is at historic lows. It cannot get much lower and may increase if inflation shows signs of life. Low rates are a double-edged sword. Low rates may stimulate the economy which in turn increases employee wage and salary income. On the other hand, Montana's earnings from trust funds and excess cash decrease fairly quickly at reduced rates. Investment income reported for income tax purposes also declines, although this effect is delayed.

Corporate Profits - In light of the "Great Recession", a significant risk is the impact of the net operating loss (NOL) carry back provisions provided in 15-31-119, MCA. A NOL generally occurs when deductions exceed gross income. If for any taxable period a net operating loss is sustained, the loss must first be accounted for as a carry back to each of the three taxable periods proceeding the taxable period of the loss. If the NOL deductions cannot be fully deducted from the prior years, the remaining deductions may be carried forward to each of the five taxable periods following the taxable period of the loss. Typically, the NOL can be fully deducted through the three period carry back. The loss is deducted against taxes that have usually been paid prior to the period of the loss and refunds are issued for the paid taxes. This

situation makes the impact of corporate NOL's on total fiscal year collections appear even greater than they may have been, because much of the effect is realized in the current fiscal year.

Energy Prices – If the global economic recovery continues to be gradual, demand for energy commodities, primarily oil and natural gas, may be slow to recover. Conversely, if a "double dip" recession occurs, reduced prices could prevail until a more vibrant economic recovery occurs.

Equities – The equity markets can play havoc on state general fund revenues. A significant portion of non-labor income is derived from net capital gains and interest and dividend income. Just because the equity markets are increasing does not necessarily mean state revenue will increase. In order for a gain to materialize, investors need to sell equities at a higher price than they paid for them. Conversely, investors may sell equities at a loss, thereby offsetting other types of income. Losses can be carried forward at $3,000 per year until the loss is liquidated.

Federal Tax Policy – Federal tax policy could impact state general fund revenues either positively or negatively. At this time Congress has adjourned until November 15 without taking any action on the Bush tax reductions. Without Congressional action, these reductions will expire on January 1, 2011. No action could translate to higher tax revenues especially in FY 2011. Current general fund estimates are based on the tax law changes without any adjustments for taxpayer behavior. Any modifications to the Bush tax reductions would require further research once a proposal is available.

Major revenue source contributors to the state general fund (and interrelated state special funds) are experiencing deep declines from FY 2008 levels. These declines continued through FY 2010 and are anticipated to continue below the FY 2008 level by the end of the 2013 biennium. A slow gradual economic recovery should improve state general fund revenues but at a slow pace. Such unprecedented turmoil also complicates the accurate prediction of future revenues and, hence, complicates the budgeting process for the legislature.

KEY REVENUE CATEGORIES

Figure 1

	Major General Fund Revenue Sources			
	Category	Actual FY 2010	% of Total	Cumulative Percent
1	Individual Income Tax	717,834,371	44.12%	44.12%
2	Property Tax	222,509,767	13.67%	57.79%
3	Vehicle Fees/Taxes	103,861,549	6.38%	64.17%
4	Oil & Gas Production Tax	95,490,812	5.87%	70.04%
5	Corporation Income Tax	87,900,911	5.40%	75.44%
6	Video Gaming Tax	52,395,999	3.22%	78.66%
	Remaining Sources	347,151,129	21.33%	99.99%
	Total	**$1,627,144,538**		

As shown in Figure 1, individual income tax is the largest general fund revenue source followed by property tax, vehicle fees/taxes, oil and gas production tax, corporation income tax, and video gaming tax. Combined, these top six sources contributed almost 79 percent to total general fund revenues in FY 2010. When these sources are compared to the estimates establish by the 61st Legislature, the only source of revenue that exceeded the HJ 2 revenue estimate was oil and gas production tax. The economic conditions discussed above affect the anticipated revenues from these key sources.

Individual Income Tax – Individual income tax revenues are expected to increase throughout the forecast period but at a slow and gradual increasing rate. This forecast is based on a slow economic recovery with no major disruption in the equity markets and no "double dip" recession. Further erosion in employment levels could reduce the forecast.

Property Tax – Property taxes are expected to show modest growth throughout the forecast period. Since reappraisal is now complete, the probability of any significant changes in statewide property values (other than the affects of reappraisal) is limited. This revenue source should be relative stable throughout the forecast period with some anticipated growth.

Vehicle Fees/Taxes - Vehicle fees and taxes is another source of revenue that is relatively stable when compared to the income tax sources. Since a large portion of this revenue is based on the number and age of vehicles, the variation in the anticipated revenue amounts would be due to a change in vehicle counts and age distribution of the vehicles. The probability of a significant change in vehicle counts is low. The distribution of the age of vehicles, however, could potentially reduce anticipated revenue. It is assumed that the count and age distribution will not change materially during the forecast period.

Oil & Gas Production Tax – Oil and gas production tax collections could be quite volatile if there is a major disruption in supply and a significant downturn in global demand. It is expected that

this will not occur and that prices will generally grow at an inflationary amount. Production is expected to decline as the amount of barrels produced from the Bakken formation declines. If there is renewed interest in the Bakken fields in Montana, then revenues from this source could exceed current expectations.

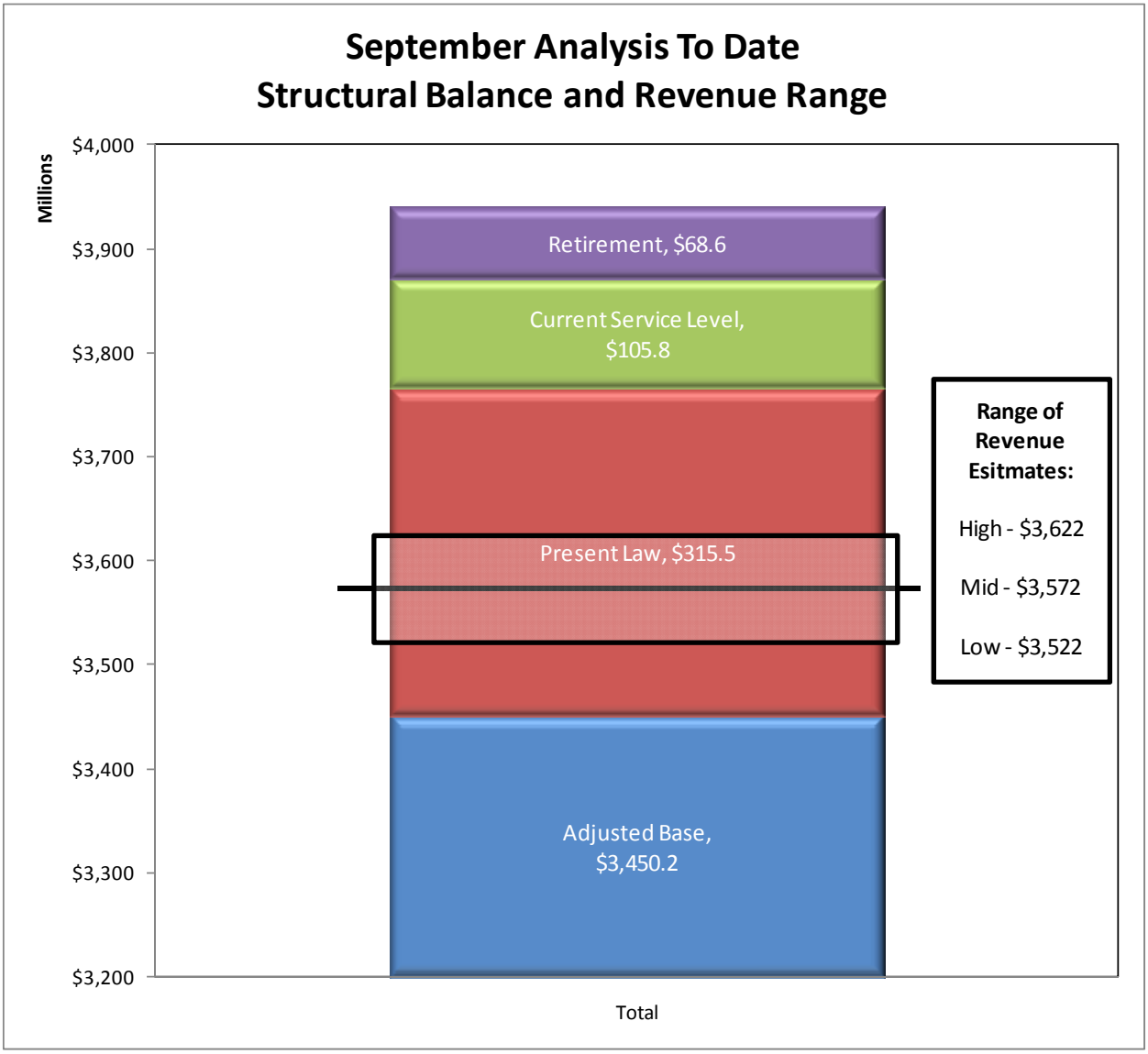
Corporation Income Tax – Corporation income tax is a volatile source because of the profitability of state and national corporations and the net operating loss carry back provisions in Montana law. If corporations continue to experience operating losses, then the outlook for corporation income taxes would be extremely bleak. The current estimates assume corporations will return to a positive profit margin throughout the forecast period. Like individual income tax, a "double dip" recession would change this outlook considerably.

Video Gaming Tax – Video gaming tax declined in FY 2010 due to the "Great Recession" and the implementation of the smoking ban. Current data suggests that the impacts have not subsided and that revenues will increase but from a much lower base. If the economy recovers quicker and/or the smoking negative impacts subside, then revenues could be higher throughout the forecast period. Neither of these conditions are expected to occur.

Remaining Sources – Generally all the remaining sources are expected to be stable when looked at from an aggregate vantage point. Some of the smaller sources are expected to decline while others are expected to increase. Overall, no material change is expected for this aggregate category.

REVENUE SUMMARY

While the FY 2011 revenues appear stronger than the February 2010 estimate, the 2013 biennium is mixed. Personal income tax collection estimates have weakened and corporation tax collection estimates have strengthened. Other revenue sources have also trended up and down. At this point in time, with significant additional data coming in a month, there is not enough data to adjust the 2013 biennium revenue estimates. Given the level of certainty of the data at this point in time, we are estimating that the revenues will be within $50 million of the estimates provided in February of $3,572 million.



FUND BALANCE UPDATE

In March 2010, the fund balance was known to include significant uncertainty. Prior to the MCA 17-7-140 reductions implemented by all three branches the fund balance was projected to be as low as negative $63 million. Since that time, many changes have occurred and may still occur before the end of the biennium:

Item	***Amount*** ***(in millions)***
MCA 17-7-140 spending reductions of all three branches	$41.0
Federal - Tier 3 FMAP	19.3
Federal - Tier 3 FMAP application to "claw back"	8.4
Federal - Enhanced FMAP extension to June 30, 2011	25.0
Federal - Additional Education ARRA (stimulus)	30.7
Otter Creek coal bonus payment	81.5
FY 2010 revenue higher than February estimate	34.9
Fund balance and prior year adjustments	18.4
Contingent on legislation - Governor's spending reductions	21.0
Contingent on court action – PPL navigable rivers funds	18.4
Total	**$298.6**

Most of the items above are estimates and may have higher or lower impacts on fund balance. Given the above variables, the biennial ending fund balance could improve by $299 million to $236 million. As discussed in the revenue assumptions, the FY 2011 revenues appear to be slightly better than estimated in February and these impacts may further improve fund balance.

BALANCE SHEET RISK

Many of the risks associated with balancing the budget for the 2013 biennium include pushing risk into the future. The legislature will need to balance the risk of current and future liabilities. If the legislature assumes that revenue in future biennia will grow faster than current revenue streams, some of this risk is mitigated. If revenues do not grow faster than current revenue streams, risk increases.

The biennial structural balance gap is reflected in the chart on page 2. The forecast level of expenditures of $3,940 million exceeds the mean forecast level of revenue of $3,572 million by $368 million.

ENDING FUND BALANCE

If the ending fund balance were partially used to offset the structural imbalance discussed above, the budget gap would be smaller. Unless revenue trends improve, using ending fund balance to fund ongoing services may create structural imbalance that delays bringing spending in line with revenues.

RETIREMENT

The purple top box of the expenditure chart is retirement costs. If the legislature chooses to delay implementation of any changes to affect the actuarial shortfall to the following biennia, the savings in the current biennia would be approximately $68 million. Risk considerations to keep in mind regarding pension plans include:

- For the public retirement systems, the analysis discussed above is based upon the pension plan actuarial valuations as of June 30, 2010. Although the equity markets have made big gains over the past two years, they continue to experience volatility. In addition, there are still two more years in which the losses of FY 2009 will be recognized by the retirement plans. What the next valuations will show at the end of the current fiscal year is unknown. Without strong investment returns and/or some other action, the expectation is that at least four pension plans will still not be actuarially sound.
- In the Teachers' Retirement System 2010 actuarial valuation, the plan's actuary shows that, without some corrective action, projected cash flow will trend downward beginning in FY 2012, turning into a negative cash flow around FY 2021 or FY 2022. A negative cash flow means that payments out of the pension fund would exceed the contributions and investment income coming into the fund. The same is likely for the Public Employee Retirement System, although the final report is not yet available. If cash flow goes negative and stays negative, it is just a matter of time before the funds run out of money.

- The fiscal health of public pension plans is looked at by bond rating agencies. If the state does not have a viable action plan for fixing an underfunded pension plan, bond ratings may suffer, increasing the cost of borrowing money.

CURRENT SERVICE LEVEL

The green, second box of the expenditure chart is the Legislative Fiscal Division definition of current service level. Examples of the type of expenditures in this group are described on page 7. If the legislature chooses to not to fund these items, the following risks should be considered:

- K-12 Education – all items in the current service level for K-12 education are components of the school funding formula that was accepted by the court as meeting the state's obligation to fund schools. Any reduction in those levels could add risk of school districts returning to court to find relief.
- Department of Public Health and Human Services (DPHHS) – items in the current service level for Health and Human Services are either services directly provided to clients, or payments to providers for providing service. Reductions in services or provider rates limit the health and other services provided to low income Montanans.
- Montana University System – items in the current service level for the Montana University System are likely to either increase tuition or reduce educational opportunities.
- Department of Commerce – items in the current service level for the various economic development programs will limit the effectiveness of the programs.

REDUCTIONS IN PRESENT LAW

Four Percent Personal Services Reductions

The OBPP budget instructions indicated that the agencies were to include a 4 percent reduction in the general fund personal services budget submission. These 4 percent reductions total approximately $9.9 million per year which exclude 24/7 and other critical positions. At this point in time, the Legislative Fiscal Division staff has not had the opportunity to evaluate the risk or reduced service resulting from this recommendation. Given that most of this reduction replaces the three percent vacancy savings adopted by the 2009 Legislature, significant additional risks are not anticipated.

Caseloads and Other

There are numerous risks with several of the major expenditures as projected in this report and in the preliminary agency budgets submitted to the Governor on September 1. Evaluation of risk in the executive budget will be further explored in the Legislative Fiscal Division budget analysis available in late December.

- Corrections – Population growth is estimated by the Legislative Fiscal Division at about 3.2 percent in FY 2012 and a further 3.1 percent in FY 2013, which is slightly higher than the increase included in the preliminary September 1 agency submitted budget to the OBPP. While based upon current population trends, this level is below historical growth levels. In addition, reduced growth rates are generally taking place in lower cost

populations such as probation and parole, while the high cost secure care population growth rate is holding fairly steady. If the overall makeup of the population changes from the goals of 80 percent community and 20 percent secure care, the overall cost of the population will rise faster than the increase in population

- Office of the Public Defender (OPD) – The caseload growth has been assumed by the Legislative Fiscal Division to remain steady based upon the most recent information available on new cases as used by the OPD. However, new cases may not be the most reliable representation of overall growth. In addition, it is unknown what impact current economic conditions may have on both crime rates and the ability of defendants to pay for legal assistance. Litigation before the Montana Supreme Court could also require changes in the office's operations that could increase costs. The agency has submitted a preliminary budget that adds costs for additional FTE, career ladder, and contract costs
- Department of Public Health and Human Services (DPHHS) - While the preliminary agency budget and Legislative Fiscal Division projected caseloads for human services are very similar over the biennium, the Legislative Fiscal Division assumes a smaller growth rate in the first year of the biennium but a steady rate of increase in the second year. The preliminary agency budget assumes a higher growth rate in the first year with no further increase in the second. If the agency projections for the first year are correct but growth does not abate in the second, costs will be higher
- In FY 2010, revenue from state lands spent on school district base aid (not including bonus payments for Otter Creek) was $51.8 million, including $4.2 million in riverbed rent payments from Avista. This amount was below the estimate for FY 2010 by $1.5 million. Beginning in FY 2012, the Avista riverbed payments will be deposited in the school facility and technology account and be unavailable to offset general fund in paying for base aid. The current estimates of revenue from state lands available for base aid in FY 2012 and FY 2013 are $50.4 million taking into account the unavailability of Avista monies. There is a risk given the shortfall in FY 2010 that revenues from state lands available for base aid will be less than currently estimated.

Adjusted Base

The reductions in the adjusted base as recommended in the OBPP budget instructions and submitted agency budgets are not anticipated to cause significant financial risk to the state in the short run. The increased risks are inherent in several areas, especially if the lower spending extends beyond the 2013 biennium.

- Insurance costs – if the agency contributions fall short of the funding necessary to pay claims, an erosion of the balance will occur. If shortfalls occur, rates may increase in later biennia to cover previous losses.
- State Capitol Complex rent – in the short run delayed maintenance will not significantly impact the functionality of work space, but over the long term deferred maintenance needs to be managed to maintain safe and productive work spaces.

Five Percent Reduction Plans

The agencies have submitted five percent reduction plans in accordance with MCA 17-7-111. Some of these options include the four percent personal services reductions discussed above and the MCA 17-7-140 reductions already included in the analysis. The remaining portions of the five percent plans total $100 million general fund and $22 million of state special funds in the biennium.

Reference Book

The Legislative Fiscal Division, in concert with the subcommittees of the Legislative Finance Committee, has developed a list of options for closing the budget gap in the 2013 biennium that the legislature may consider. These items are available on the web at http://www.leg.mt.gov/css/fiscal/reports/2009-2010-interim-reports.asp#oct2010 and consideration during session. Each of these items has its own associated reduction in service or risk to the fund balance. A brief description of these risks is included in the write-up.