REVENUE AND EXPENDITURE GROWTH ANALYSIS PROJECT STATUS

A Report Prepared for the

Legislative Fiscal Division

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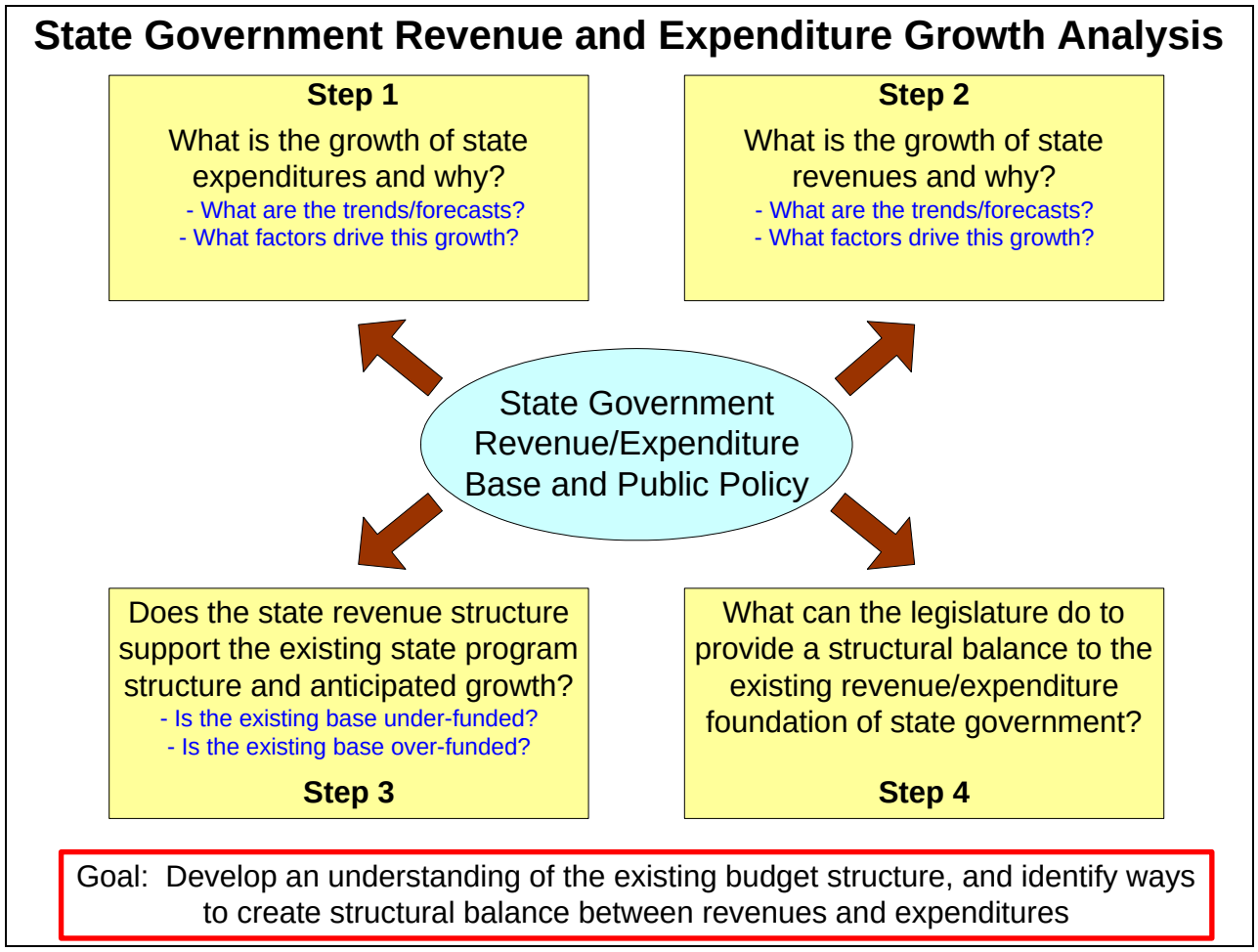
Legislative Fiscal Division

www.leg.state.mt.us/css/fiscal/

INTRODUCTION

The purpose of this document is to provide the committee with a work-in-progress status report on the "State Government Revenue and Expenditure Growth Analysis" project. This work-plan item was one of four in-depth interim studies adopted by the Legislative Finance Committee (LFC) on June 20, 2003. The following is a high level pictorial view of the study showing the four significant steps required to meet the stated goal.

WORK PLAN ITEM



BACKGROUND INFORMATION

Montana state government like any other business is influenced by economic and demographic developments. For example, Montana's economic base as well as the strength of the U.S. economy determines the level of revenues collected from personal and corporate income taxes, property taxes, natural resource taxes, and investment earnings. Similarly, both economic and demographic variables affect state government disbursements for education, human services, corrections, and other governmental services.

Montana's total revenue base is comprised of a number of taxes and fees plus numerous federal reimbursements or grants. Revenues are further enhanced from the investment of trust monies and idle cash pending disbursement from the state treasury. Since income tax is the state's largest general fund tax source, economic developments or trends in the areas of inflation, employment, and income levels significantly influence available revenues to fund governmental services.

Federal revenue correspondingly is used to fund a number of our human service, transportation, and educational services. In a number of instances, general or state special revenue fund dollars are required to provide a state match before the federal funds can be disbursed.

Conversely, Montana's total expenditure base is targeted toward educational and human service programs with a significant allocation to highway construction. Education and human service costs are driven by some of the same economic and demographic conditions that influence state revenues. If employment levels increase, this usually translates to an increase in population or a reduction in unemployment levels. With population increases comes a corresponding increase in educational and human service costs. While state revenue growth is more susceptible to income levels and economic growth, expenditure growth is influenced more by inflationary pressures, population trends, and demographic characteristics.

Ever since the mid eighties, legislators have expressed an ever-increasing concern over the growth in state government expenditures. During this period, most legislative sessions were faced with projected deficits or the prospect of too many demands for the dollars available. From historical financial data, it is obvious that the costs of governmental services have increased over time. What has not been apparent is the "drivers" behind these increased costs and what options the legislature may have to control these costs in the future.

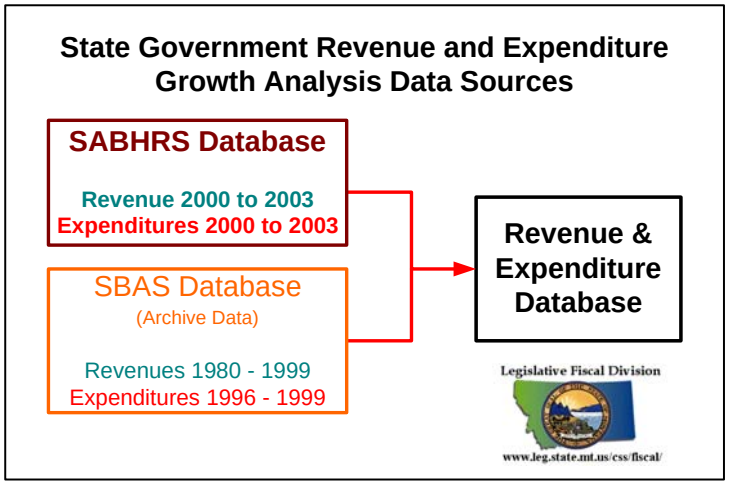
Conversely, state revenues have also increased but not necessarily at the same rate as the growth in expenditures. During these periods of revenue "gaps", one-time transfers, temporary tax increases, accounting modifications, and/or tax accelerations were used to bridge the gap between anticipated expenditures and available revenue. These temporary fixes were enacted under the premise that future revenues would eventually "catch up" to the costs of providing governmental services. Furthermore, while growth in state revenues is usually correlated to economic activity, it is unknown whether Montana's tax structure is sufficient to support the existing expenditure base let alone future growth.

Maintaining a balance between on-going revenues with on-going expenditures is critical to the financial health of state government. Before this goal can be achieved, the legislature needs to understand what drives the growth in state expenditures and whether the state's tax structure is sufficient to support this expenditure base. With this information in hand, the legislature can begin to adequately address public policy issues relevant to tax policies and governmental services provided.

PROJECT DEFINITION

DATA ISSUES AND LIMITATIONS

This study is based on financial data extracted from the legacy computer system (SBAS) and the new PeopleSoft system (SABHRS). Data extracted for the expenditure analysis is for the historical period fiscal 1996 through 2003 (eight years). This study period was chosen because of significant government reorganizations that took place prior to this time. Since necessary data was retrieved from the two separate computer systems, data consistency issues were encountered. For example, there were numerous instances where the encoding procedures used with SBAS were modified under SABHRS. In some situations, encoding differences were



encountered from one fiscal year to another. To the extent possible, staff has attempted to show the data in the most consistent, comparable manner.

Data extracted for the revenue analysis is for the historical period fiscal 1980 through 2003 (24 years). Unlike the expenditure analysis issues, the classification of revenues does not change significantly over time. However, since necessary data was retrieved from the two separate computer systems, data consistency issues were also encountered. To the extent possible, staff has attempted to show the data in the most consistent, comparable manner.

Step 1 (See Example 1 and 2)

This step of the study is designed to provide the legislature with a comprehensive understanding of what causes the growth in state government expenditures. While the focus of this study is on general fund expenditures, expenditures in the general, state special, and federal special fund types were used in the analysis. This task will be accomplished by an examination of global state expenditures (personal services, medical costs, contracted services, information technology, etc.) and expenditures for each agency over the period fiscal 1996 through 2003. The analysis will include an identification of the major drivers relevant to the cost of the services provided. Examples of "drivers' would be FTE's, caseloads, ANB, services provided, federal match requirements, etc. In addition to these drivers, significant factors that have had an influence on the costs over the study period will be highlighted. These factors will be categorized as economic, legislative, management, legal, social, and business. With the identification of drivers and factors, the reasons for significant changes in expenditures will be documented.

The analysis will also include a comparison of the expenditure growth with the growth in Montana's total personal income. Since total personal income is an indicator of economic growth in the state, this comparison will give the legislature a perspective of costs changes as compared to changes in economic activity in Montana. Other comparisons may be shown depending upon what might be relevant for a specific expenditure area. These comparisons might be with such items as consumer price indices, crime statistics, poverty levels, etc.

The final and critical component of the analysis is a summarization of the long-term growth rate potential for agency expenditures. This section of the analysis will summarize issues relevant to future growth for the services provided and a long-term growth rate expectation for the agency. This growth rate will be based on a historical analysis that will represent an approximation of what may be expected in the future assuming there will be no significant policy changes in the future.

Status of Step 1 – Analysis currently underway.

Step 2 (See Example 3)

This step of the study is designed to provide the legislature with a comprehensive understanding of what causes the changes in state government revenues. This task will be accomplished by an examination of each general fund revenue source over the period fiscal 1980 through 2003. The analysis will include an identification of the major drivers relevant to the revenue collected. Examples of "drivers' would be income taxed, tax rates, net profits, minerals produced, licenses issued, etc. In addition to these drivers, significant factors that have had an influence on the revenue received over the study period will be highlighted. These factors will be categorized as economic, legislative, management, legal, social, and business. With the identification of drivers and factors, the reasons for significant change in revenues will be documented.

The analysis will also include a comparison of the revenue growth with the growth in Montana's total personal income. Since total personal income is an indicator of economic growth in the state, this

comparison will give the legislature a perspective of revenue changes as compared to changes in economic activity in Montana.

The final and critical component of the analysis is a summarization of the long-term growth rate potential for each revenue source. This section of the analysis will summarize issues relevant to future growth for the revenue source and a long-term growth rate expectation. This growth rate will be based on a historical analysis that will represent an approximation of what may be expected in the future assuming there will be no significant policy changes in the future.

Status of Step 2 – Analysis currently underway.

Step 3

This step of the study will answer the fundamental question "is the current state revenue structure sufficient to support the existing expenditure base." This analysis will be based on the results of steps 1 and 2 above where a weighted average growth rate for revenues and expenditures will be computed. If the long-term growth rates for anticipated revenues exceed the long-term growth rate for expenditures, then the public policy implications of this scenario may be significantly different if revenue growth is less than expenditure growth. Regardless of the outcome, the legislature will have valuable information that will assist them in crafting fiscal direction for both tax policy and governmental services provided.

Status of Step 3 – Cannot complete until steps 1 and 2 are complete.

Step 4

This step of the study will depend on the outcome of step 3 above. If the long-term growth rates for revenues exceed the long-term growth rate for expenditures, then options to create a structural balance will not be required. However, the legislature may still desire to examine tax policies and governmental services provided. If revenue growth is less than expenditure growth, then staff will provide policy options the legislature may want to consider to achieve structural balance. This step of the analysis could be extremely sensitive and viewed as political by both parties. Since the committee fully supported this study, staff assumes the options provided would be viewed as a non-partisan effort to provide the legislature with a variety of public policy options that will empower the legislature to craft innovative and creative solutions to a structural imbalance.

Finally, the heart and purpose of this pro3ject and the "Analysis of State Program Priorities" project is encapsulated in issues and options for consideration by the legislature. Issue development is necessary to aid the legislature in understanding the macro and legislative policy factors at work and how and whether they can be influenced.

Status of Step 4 – Identifications of options are underway.

PERSONAL SERVICES

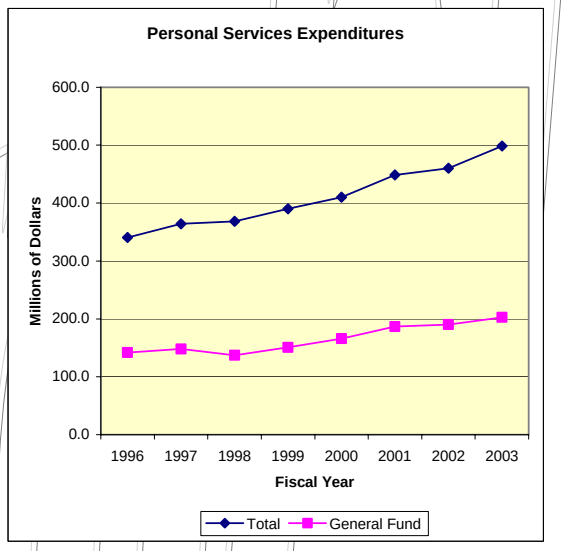
EXPENDITURE DESCRIPTION: "Personal services" is a term that incorporates all costs of state employees. Usually it refers to the costs of salary and various benefits, including employer contributions to group insurance, social security, Medicare, workers' compensation, unemployment insurance, and retirement. It does not include contracted services (consulting or professional services under operating expenses category). In this analysis, only general fund, state special revenue funds, and federal funds are included in total funds. It is important to note that personal services costs that are part of larger distributions to other governmental entities, such as the university system or K-12 education, are not included in these numbers. Regardless of that, the total funds expenditure shown for 2003 below is approximately 15 percent of the total general fund, state special revenue funds, federal funds expenditures.

Expenditure History:

Personal Services Expenditures
1996 - 2003 ($ in millions)

Fiscal Year	Total Funds	General Fund	GF Percent Change
1996	340.598	141.649	
1997	364.140	148.020	4.50%
1998	368.328	137.259	-7.27%
1999	389.884	150.680	9.78%
2000	410.302	165.814	10.04%
2001	448.652	186.567	12.52%
2002	460.078	190.207	1.95%
2003	498.622	202.513	6.47%

Total funds includes GF, SSR, & FF



Major Drivers:

- Pay plan changes
- Number of state employees
- Cost of employer paid benefits (FICA, Medicare, UI, workers compensation insurance, retirement, etc.)

Potential Factors Influencing Change:

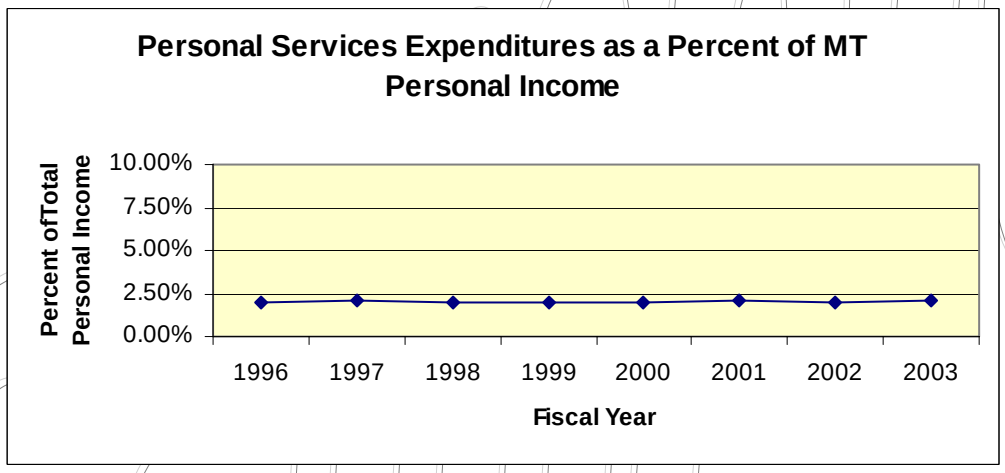
- Economic Factors
  - Cost of living pressures
  - Rising medical costs
  - Aging workforce
- Legislative Factors
  - Change in salary schedules
  - Change in state contribution for group insurance
  - New or expanded programs
  - Availability of funding
- Executive or Management Factors

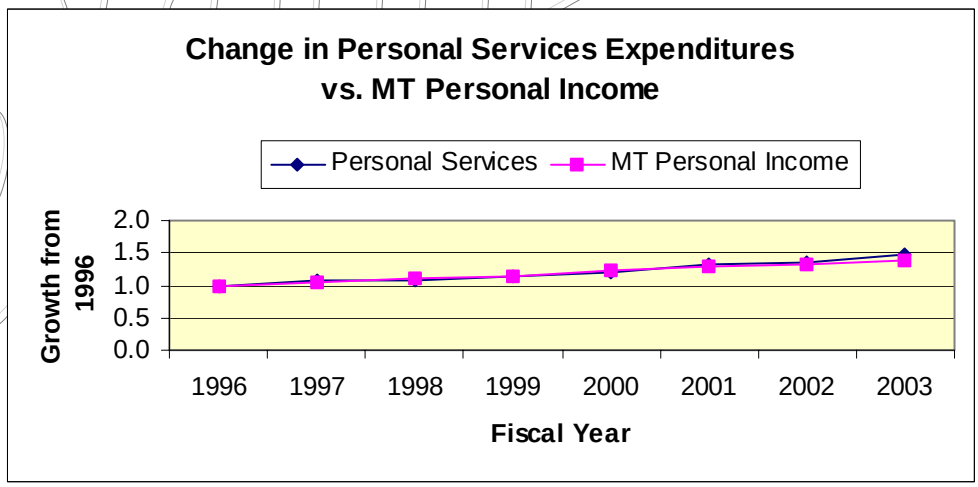
- Change in position role
- Supply of qualified applicants
- Workload
- New mandates or opportunities, with funding (budget amendments)

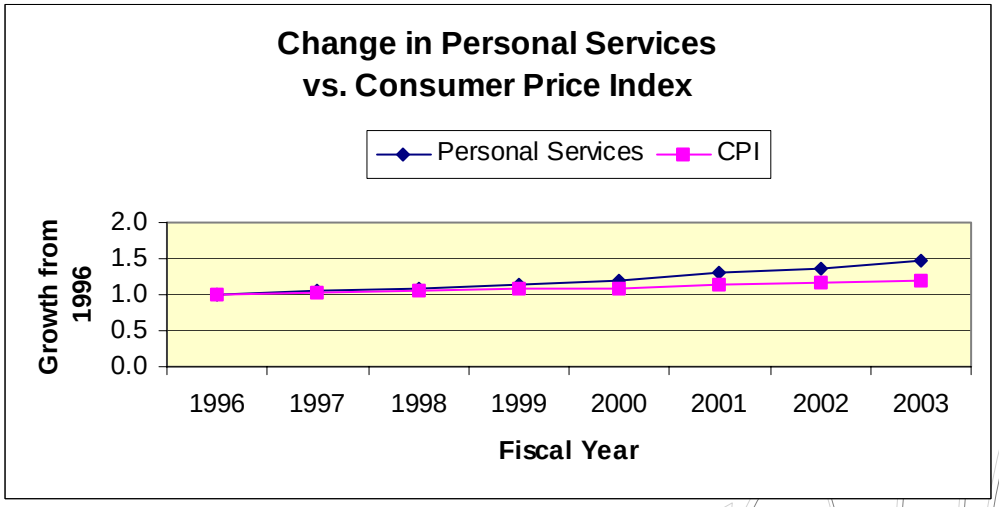
Reasons for Historical Changes:

- The average annual growth in personal services expenditures (GF, SSR, and FF) from 1996 through 2003 was 5.6 percent (5.3 percent if group insurance is excluded).
- The salary component of the state employee pay plan grew at an average annual rate of 2.6 percent.
- The state contribution to the employee group insurance plan grew at an average annual rate of 6.2 percent.
- Statewide, the number of FTE from 1996 to 2003 grew by an average annual rate of 1.7 percent (all FTE regardless of funding source).
- The average state employee salary grew from $25,375 in 1996 to 33,981 in 2003, an average of 4.3 percent per year, and an indication of a continuing shift to more technical, increasingly professional workers on top of the authorized pay plan increases. (Source of data: *State Employee Profile* – Dept. of Administration Personnel Division).

Relationship to Significant Economic Measures:







Long Term Growth Potential

- The growth should slow in fiscal 2004 and fiscal 2005 because the legislature approved a lower than average 25-cent per hour increase effective January 1, 2005 (a 0.75 percent raise in fiscal 2005 and 1.5 percent if figured on an annualized basis). Years beyond 2005 cannot be predicted because of numerous variables.
- Other components of personal services expenditure changes may continue to grow as the supply of qualified employees decreases with the retirement of an aging workforce, resulting in reclassification of positions, and with continuing innovation in technology.

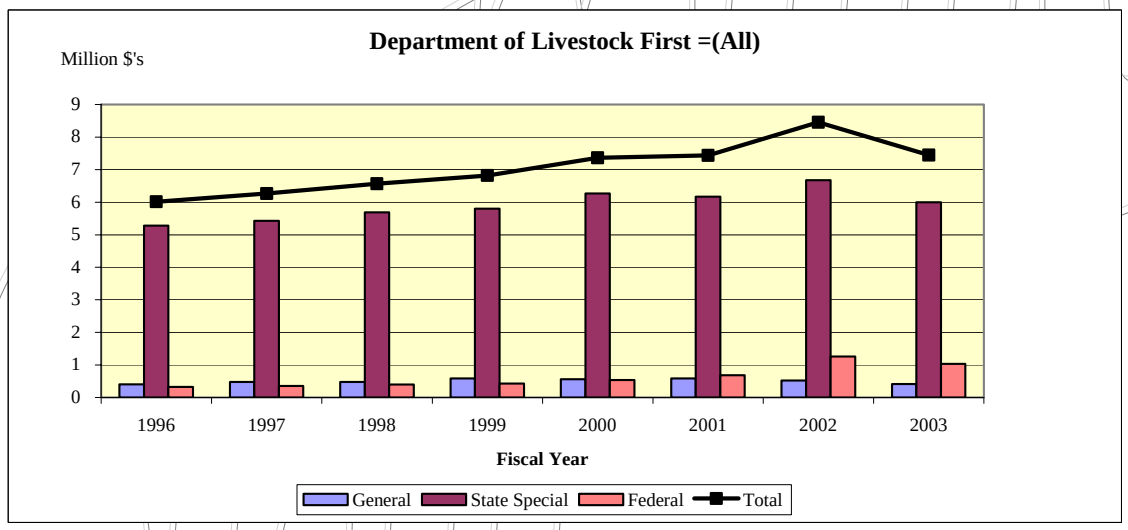
DEPARTMENT OF LIVESTOCK

EXPENDITURE DESCRIPTION:

The Department of Livestock is responsible for controlling and eradicating animal diseases, preventing the transmission of animal diseases to humans, protecting the livestock industry from theft and predatory animals, and regulating the milk industry relative to producer pricing. The department, which is provided for in 2-15-3101, MCA, consists of the Board of Livestock and its appointed executive officer; the Livestock Crimestoppers' Commission; and the Beef Research and Marketing Committee. The department is organized into five divisions: Animal Health, Centralized Services, Brand-Enforcement, Diagnostic Laboratory, and Meat, Milk, and Egg Inspection. The 57th Legislature added the Board of Horse Racing and its staff to the Department of Livestock. The Board of Livestock, which is the statutory head of the Department of Livestock, consists of seven members appointed by the Governor and confirmed by the Senate to serve six-year terms.

Expenditure History:

Fiscal *Year*	General Fund	State Special Fund	Federal Fund	Total Fund
	01000	*02000*	*03000*	
$'s Expended				
1996	409,510	5,280,104	323,783	6,013,398
1997	483,789	5,426,323	354,968	6,265,080
1998	479,946	5,686,293	402,331	6,568,570
1999	585,636	5,802,411	429,559	6,817,606
2000	564,844	6,262,062	539,036	7,365,941
2001	589,297	6,165,642	683,891	7,438,831
2002	521,679	6,670,527	1,262,218	8,454,424
2003	411,904	6,001,265	1,033,678	7,446,847
% of Total (2003)	5.5%	80.6%	13.9%	100.0%
Avg. Growth	0.083%	1.85%	18.05%	3.10%



<u>Note:</u> The spike in federal funding in 2002-2003 represents Bison Control & Management Program around Yellowstone National Park

Major Drivers:

- Personal Services (account for 74% of Department expenditures)
  - Number of FTE's
  - The number of producers and operators (ranches, dairies, slaughterhouses, auction houses, etc.)
  - General Fund match required for USDA Federal funding for meat inspectors

Potential Factors Influencing Change:

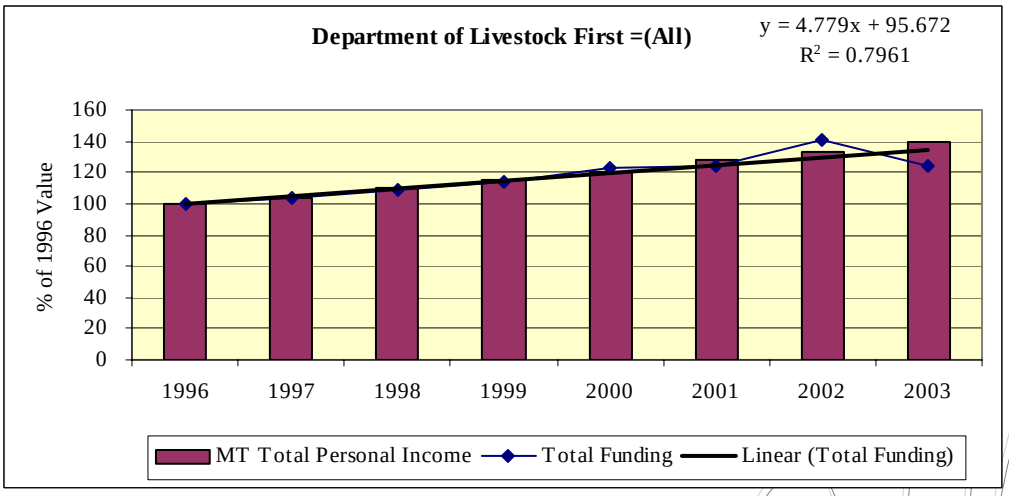
- Economic Factors
- Legislative Factors
- Executive or Management Factors
  - Pay Plan changes (Department moved to Broadband Pay Plan 20 in 2002)
  - Animal health issues requiring testing & surveillance (e.g. BSE, avian flu, brucellosis, etc.)
  - Interstate and international trade regulations
  - USDA and FDA inspection regulations (meat, poultry and milk)
  - Bison population
  - Predator population
- Legal Factors
- Social Factors
- Business Factors

Reasons for Historical Change:

- There was a three-year spike in general fund expenditures in 1999-2000 which can be attributed to:
  - A philosophical shift towards supporting functions that are defined as "public health/safety" with general fund rather than state special revenue (producer fees). This shift was reflected in funding allocations for the Central Services Division, which provides administrative support for all Department functions, and in the Diagnostic Lab.
  - Vehicle replacement costs in the Inspection Division during these years.
  - An increase in FTE's for meat inspectors, which requires a general fund match of USDA funds.
- State special revenue expenditures experienced only moderate growth until 2002 due to:
  - The reorganization that brought the Board of Horseracing to Livestock from Commerce, which is funded entirely through self-generating state special revenue.
  - With increased meat inspectors and inspections, there has been a concurrent increase in the overtime costs for those inspectors who travel extensively.
- There has been significant growth (18% average) in federal special revenue expenditures attributable to the federal bison management program (brucellosis control) in and around Yellowstone National Park.
- General fund expenditures were subsequently reduced in fiscal year 2003, starting with executive mandated cuts, and have been sustained in large part, through indirect cost charges against federal grants. This allows a cost shift, primarily in Centralized Services, from general fund to federal special revenue.

Relationship to Significant Economic Measures:

- The average Department growth rate from fiscal 1996 to 2003 = 3.10%
- The average US consumer price index in fiscal 1996 to 2003 = 2.38%
- The average MT Personal Income growth in fiscal 1996 to 2003 = 4.81%



Long Term Growth Potential:

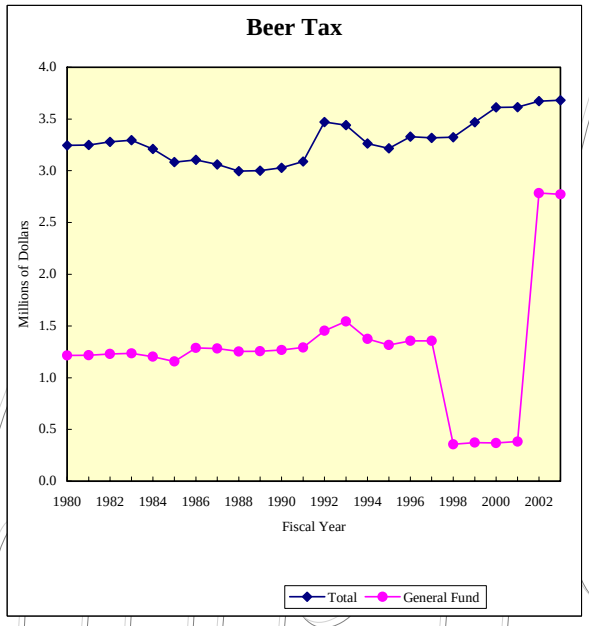
With personal services representing 74% of the Department expenditures, future predictable growth potential is likely tied to all costs related to employing FTE's (salaries, overtime, benefits). There are some emerging issues, however, that may have a major unpredictable impact on the Department of Livestock. These issues include BSE, mad-cow disease, and the avian flu outbreak in Asia. Both may well lead to new and/or increased regulations that could trigger additional inspection responsibilities, increased laboratory testing and surveillance, as well as increased tracking of animals involved in interstate/international commerce. The impact of these two issues may go well beyond just these two animal diseases and create consumer demand for new regulations throughout the livestock and agriculture industries.

BEER TAX

REVENUE DESCRIPTION: A tax is levied on each barrel of beer (31 gallons) produced in or imported into Montana based on the amount produced. A small portion of the revenue from the beer license tax is returned to Indian tribes per an agreement between the Department of Revenue and the tribes.

Revenue History:

	Fiscal Year	Total Collections Millions	General Fund Collections Millions	GF Percent Change
A	1980	3.244011	1.216504	
A	1981	3.249022	1.218383	0.15%
A	1982	3.279701	1.229888	0.94%
A	1983	3.295482	1.235805	0.48%
A	1984	3.211297	1.204236	-2.55%
A	1985	3.083163	1.156186	-3.99%
A	1986	3.105743	1.287765	11.38%
A	1987	3.060956	1.281316	-0.50%
A	1988	2.997014	1.254564	-2.09%
A	1989	3.000273	1.255928	0.11%
A	1990	3.028992	1.267950	0.96%
A	1991	3.089077	1.293102	1.98%
A	1992	3.470874	1.452896	12.36%
A	1993	3.441481	1.545395	6.37%
A	1994	3.263345	1.375734	-10.98%
A	1995	3.215598	1.316559	-4.30%
A	1996	3.329868	1.356496	3.03%
A	1997	3.318449	1.356720	0.02%
A	1998	3.324479	0.358284	-73.59%
A	1999	3.469910	0.373965	4.38%
A	2000	3.613076	0.370418	-0.95%
A	2001	3.614271	0.384630	3.84%
A	2002	3.673818	2.783903	623.79%
A	2003	3.680560	2.771455	-0.45%



Major Drivers:

- Barrels of beer sold
- Tax rate

Potential Factors Influencing Change:

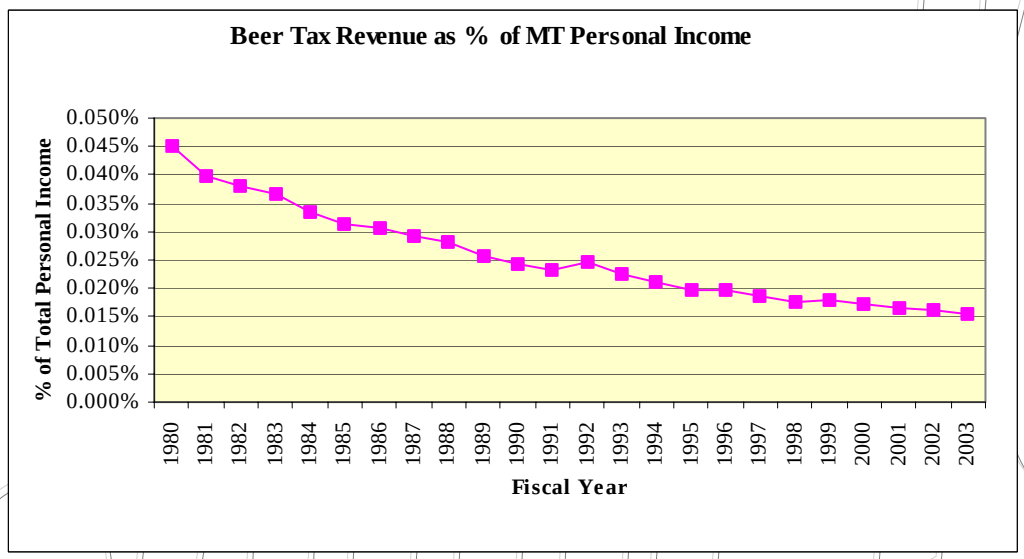
- Economic Factors
  - Personal income change
  - Population change
- Social Factors
  - Government or industry announcements (i.e. health risks or benefits)
  - Demand of substitutes such as wine
- Legislative Factors
  - State legislative impacts
    - change price/tax
    - change legal age for consumption
    - degree of law enforcement
    - lower legal limit to 0.08
    - allow wine to be sold in grocery stores
  - Federal legislative impacts
    - Change price/tax

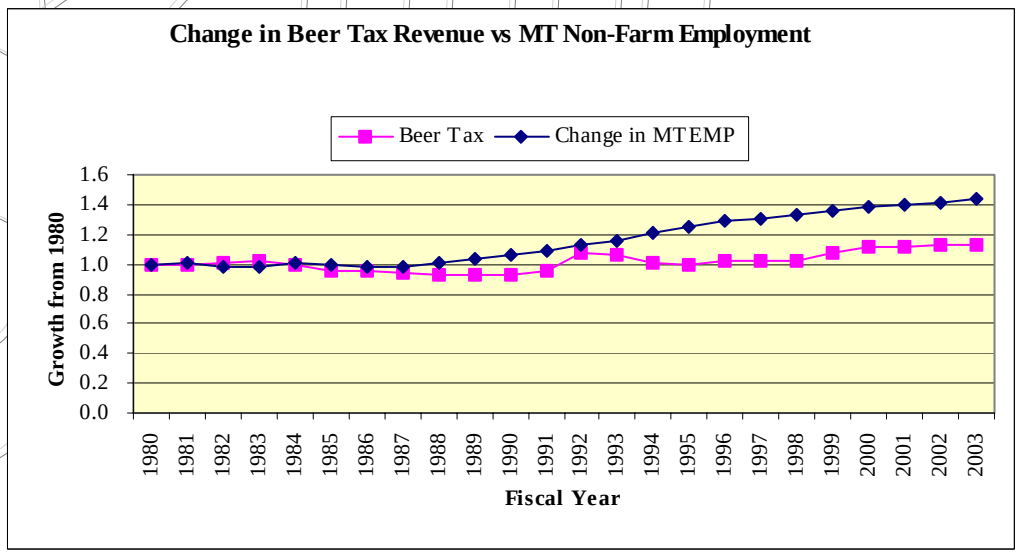
- Force state to adopt lower legal limit
- Force state to adopt open container law

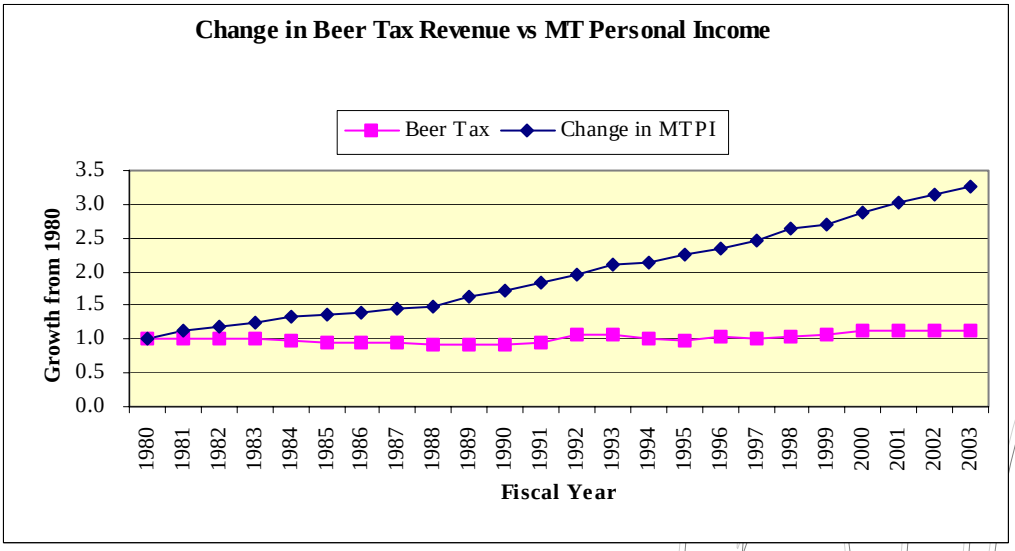
Reasons For Historical Changes:

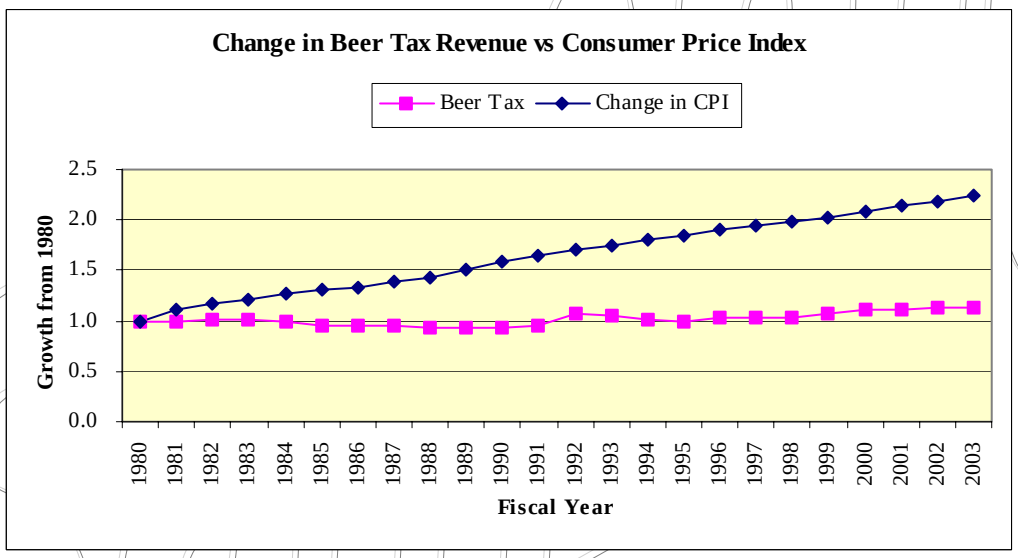
- Tax Changes
  - Fiscal 1986 – increased tax $0.30 (House Bill 374, Chapter 721)
  - Fiscal 1993 & 1994 (September 1992 to August 1993)– temporarily increased tax by a 7% surtax in the July 1992 special session (HB 44, Chapter 15)
- Economic Changes
  - Greater consumption in later half of the 1990's possible due to thriving economy
  - Decline in consumption in the mid 1980's possible due to sluggish economy

Relationship to Significant Economic Measures:









Long Term Growth Potential:

Beginning in fiscal 1989, total barrels of beer sold have shown a gradual increase over time with some fluctuation from year to year. This trend, when computed from fiscal 1989 to 2003, shows an average growth rate of 1.73 percent.

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