LFD GENERAL FUND PRELIMINARY BUDGET OUTLOOK "BIG PICTURE REPORT" 2007 BIENNIUM

A Report Prepared for the

58th Legislature

By the

Legislative Fiscal Division

October 6, 2004

Legislative Fiscal Division

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INTRODUCTION

PURPOSE

The purpose of this report is to provide the Legislative Finance Committee (LFC), the Revenue and Transportation Committee, and the members of the legislature with a preliminary projection of the general fund balance for the 2007 biennium at present law levels of revenue and expenditure. The projection estimates the availability of funding for maintenance of existing services as well as for new and expanded programs. This report is intended to provide a broad overview of the scope of present law fiscal issues the legislature may face in the 2005 session, and the starting point, or benchmark, for crafting the 2007 biennium budget priorities. These projections are based on "broad brush" general assumptions of expenditure and revenue patterns from the most current available information, and will be refined as staff undertakes detailed budget analysis and revenue estimation in preparation for the 2005 legislative session.

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

SCOPE OF REPORT

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

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

The projections do not include other fiscal issues that may face the 2005 legislature, including executive or legislative new proposals/initiatives, the impact of the K-12 school funding court decision, other potential FY 2005 supplementals, other pending litigation, or the potential impact of voter initiatives. These issues are listed in Table 3 and are discussed beginning on page 12 of this report.

"MODEL" APPROACH

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

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

Table 1 – Statutory Present Law

Table 1 reflects only those projections that fit neatly into the statutorily prescribed definition of present law. Caution is encouraged, however, in relying solely on that projection in assessing the factors the legislature needs to take into consideration in adopting a balanced budget for the 2007 biennium. It does not take into consideration what is considered a prudent ending fund balance reserve, nor does it include any reserve for unbudgeted but likely major expenditures such as wildfire suppression and other natural disasters.

Table 2 - Reserves

Factoring in a reserve for an ending fund balance and such known issues as fire and other emergency costs is critical to good fiscal policy, and as such, recommended estimates for such allowances are provided in Table 2, largely based on historical actions by the legislature and on sound fiscal practice. They are, however, subject to less clarity than the estimates in Table 1, and the distinction is made on these more "policy oriented" issues so that the reader can draw a separate and distinct conclusion about the merits of the estimate. In general, however, the projected fund balance after taking into consideration LFD recommended adjustments is likely to be a more realistic projection of the level of funds available after funding present law and adequate reserves. Table 2 also addresses the issue of structural balance, identifying the amount of the excess that can be spent without creating structural imbalance.

Table 3 – Potential Impacts Not Included

Yet another distinction is made in Table 3 for those issues with potential impacts on the 2007 biennium budget for which the impact is either highly uncertain or unknown, depending on subsequent economic or other events. A prime example is the impact of the K-12 school funding decision, which is still in the courts. Inclusion of this or any of the other issues in Table 3 in the projections would be highly speculative at this point, but clearly they need to be considered in any assessment of the budget picture for the 2007 biennium, and in legislative deliberations to balance the budget.

It is strongly recommended that all three levels of information be taken into consideration in developing conclusions about the budget projections for the 2007 biennium. By presenting it in this 3-tier fashion, it allows the reader to use the presentation as a model, and to "pick and choose" their estimates for the items, particularly in Tables 2 and 3, in arriving as their own perspective of the status of the 2007 biennium budget outlook.

2007 BIENNIUM BUDGET PROJECTION

PROJECTED GENERAL FUND BALANCE

Present Law

The projected present law ending general fund balance for the 2007 biennium before reserves is $277.8 million (Table 1), and is reduced to $205.9 million (Table 2) when allowing for a 2 percent ending fund balance reserve, a reserve for wildfire suppression costs, and a reserve for expenditures from the emergency fund appropriation. This total represents an available balance for policy decisions on prioritization of present law expenditures, new initiatives, tax reform, and an appropriate general fund reserve.

2007 Biennium General Fund Outlook
In Millions
Table 1

Beginning Fund Balance (Before Supplementals)		**$175.848**
Anticipated Revenue		**$2,850.407**
Disbursements		
Fiscal 2005 Supplementals		7.389
Fiscal 2004 Base times 2 (Excl. stat. approps.)		2,275.572
Present Law Adjustments		154.551
Public Schools	19.915	
Public Health	86.695	
Corrections	14.901	
Higher Education	1.632	
Judiciary	4.536	
All Other Agencies	5.808	
Other Adjustments	21.064	
Fiscal 2004 Base times 2 (Stat. approps. + trnf.)		273.303
Statutory Appropriations		18.841
Transfers		18.826
Total Disbursements		**$2,748.482**
Projected Balance Without Reserves		**$277.773**
Table 2		
LFD Recommended Reserves		
2.0% Fund Balance Reserve	57.008	
Wildfire Suppression Cost Reserve	14.091	
Emergency Appropriation Reserve	0.800	71.899
Projected Present Law Excess		**$205.874**
Projected Present Law Excess Components		
Revenue Less Disbursements		**$87.034**
Remaining Balance		**$118.840**
Table 3		
Other Significant Issues Not Addressed Above		
Other Potential 2005 Biennium Supplementals		
2007 Biennium Pay Plan		
Litigation Issues		
K-12 Funding Adequacy		
Highway Patrol Pension Fund		
Human Services		
PPL Protested Tax		
DPHHS Issues		
Tobacco Settlement Revenue		
Medicaid Waiver		
Federal Medicare Drug Prescription Benefit		
Other		
Public Defender Study		
Ballot Initiatives		
Constitutional Amendment C-40		
Initiative I-149		
Federal Funds		
Federal Transportation Fund Plan (TEA21)		
Corporation License Tax		
Personal Property Tax Rate Trigger		
New Proposals and Other Initiatives		
Economic Uncertainty and Revenue Trends		

As discussed in the previous section, Table 1 represents only those projections that neatly fit the statutorily prescribed definition of present law. It is not, however, a complete picture of the available fund balance, since it doesn't take into consideration an adequate fund balance reserve or allowances for fire and emergency costs. Factoring in an allowance for these issues is sound fiscal policy, and since they generally represent policy oriented issues of the legislature as to the amount of the allowance, they are singled out individually and are presented as LFD recommendations in arriving at a more realistic projection of the level of funds available after funding present law and adequate reserves. These recommendations are discussed in more detail beginning on page 11.

The projections do not include allowances for other potential fiscal issues with an uncertain or unknown impact (Table 3). Although not included, the reader should be aware of

these potential impacts and factor them in to their assessment and conclusions about the general fund outlook for the 2007 biennium.

While Table 2 shows a present law excess after reserves of nearly $206 million, it is important to consider the issue of structural balance of the general fund before concluding whether the entire excess can be used for state services and tax policy initiatives of an ongoing nature. For the 2007 biennium, anticipated revenues exceed present law disbursements by just over $87 million (Table 2). Therefore, only $87 million of the projected $206 million projected excess could be used for ongoing state services growth or tax policy initiatives without creating a structural imbalance. The remaining $119 million should only be used for one-time initiatives if a structural balance is to be maintained. For a further discussion of this issue, see the discussion of "Structural Balance" on page 17.

The nearly $206 million projected present law excess provides a stark contrast from the $230 million negative balance the 2003 legislature originally faced in crafting a budget for the 2005 biennium, which left insufficient funds to even continue existing programs and services at current levels. The primary reasons that have contributed to this improvement are a stronger than anticipated growth in actual and projected general fund revenue collections (primarily income taxes and gas and oil).

BASIC ASSUMPTIONS USED IN PRESENT LAW PROJECTIONS

Concept of Present Law

The provision of a present law budget projection represents a starting point for legislative budget deliberations, and complements the statutory requirement that the executive and legislative staff present/analyze a present law budget. Present law is defined as "that level of funding needed under present law to maintain operations and services at the level authorized by the previous legislature…" Present law serves as a benchmark to aid the legislature in prioritizing budget issues between maintenance of existing services and provision of new services or tax policy initiatives. The projection of a present law budget does not presume the legislature will adopt a budget that retains all existing services. But the executive must present a present law budget to the 2005 legislature, and both new initiatives and reductions or adjustments in existing services must, by law, be presented as new proposals for the legislature to consider in crafting a budget.

Present law projections include 2007 biennium fund balances at present law operations. Present law is used rather than actual FY 2004 expenditures in order to account for inflation and other costs, such as annualization of the state employee pay plan. It is also used because statute requires the executive to submit a present law budget, and the LFD to provide a present law analysis. Present law expenditures are at the levels established by the legislature in the 2003 session for ongoing services, with adjustments for caseload and enrollment increases. The present law projections do not include funding for increases in employee pay, adjustments to the K-12 Base aid funding schedules, or human services provider rate changes beyond the changes made by the 2003 legislature. No funds are included for new programs, tax policy revisions, or legislative initiatives.

Revenues

Revenues included in the 2007 biennium projections are estimated collections under state and federal law and accounting procedures, with the rates and allocation percentages as specified under current law. The projected revenues for FY 2006 through 2007 contained in this report are preliminary estimates, based on FY 2004 actual collections and current economic trends. These revenue projections will be subject to more in-depth analysis and refined later in calendar 2004, as the Revenue and Taxation

Committee undertakes its statutory duty to prepare a revenue estimate for presentation to the 2005 legislature.

It should be noted that the complexity in estimating individual income taxes is especially difficult for this budget cycle. The most recent tax return data available for analysis is CY 2002. The CY 2003 data will not be available until early November.

In addition to dated data, federal tax reform legislation was effective January 2003 with a significant number of modifications to federal statute. Since reduced federal taxes paid typically result in higher state taxes, it is imperative that any federal tax changes are factored into the state income tax estimate. For some of these federal changes, the simulation model to estimate state income taxes used by both the Office of Budget and Program Planning and LFD can be adjusted to reflect the fiscal impacts of the legislation. Other provisions, such as bonus depreciation and accelerated expensing of purchases, cannot be incorporated into the model and must be estimated by less reliable methods.

The final complexity involved in estimating individual income taxes is the implementation of the state tax reform legislation (SB 407) enacted by the 58th Legislature. The individual income tax provisions of this legislation are effective January 1, 2005 with a subsequent capital gains tax adjustment effective on January 1, 2007. As with federal tax reform measures, most of the state modifications can be incorporated into the simulation model. To the extent there are taxpayer behavioral changes, however, the model cannot be adjusted and less reliable methods must be used.

Expenditures

Actual expenditures in FY 2004 are used as the starting point for base expenditures. Actual expenditures, minus one-time-only expenditures, were doubled to provide a base from which present law increases were calculated.[1] The following additional general adjustments were made in projecting present law costs into the 2007 biennium:

- Personal services costs are at the level of FTE used to calculate 2005 biennium personal services costs by the 58th Legislature, with adjustments to reflect continuation of the 2005 biennium pay plan
- Anticipated enrollment changes in K-12 and the university system have been included
- Caseload and entitlement adjustments in human services and corrections programs (including Medicaid and prison population) anticipated under present law are included
- Budget modifications and miscellaneous ("cat and dog") appropriations enacted by the 58th Legislature are excluded if they were designated as one-time expenditures, while those funding ongoing duties are included in the present law projections
- Appropriations phased in during the 2005 biennium are funded for the entire biennium (e.g., pay plan)
- Vacancy savings is taken as a reduction from total personal services to reflect that, due to position vacancies and other personnel policies, less than full funding of personal services is sufficient to meet agency employment obligations. Historically, the legislature has implemented some form of vacancy savings, and the typical average vacancy savings rate adopted in legislative budgets in recent biennia is 4 percent (the percentage used in this projection)

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

Any budget reductions enacted for the 2005 biennium by the 2003 legislature in regular session are continued, with the exception of an across-the-board reduction in FTE funding. Due to the nature of the way personal services are funded, the action by the 2003 legislature did not eliminate these positions from the calculation of present law personal services. Those costs are therefore funded for the 2007 biennium.

ADJUSTMENTS APPLIED TO DERIVE PRESENT LAW

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

Revenues

General fund revenues of $2.745 billion for the 2005 biennium are anticipated to increase by $105.9 million to $2.850 billion for the 2007 biennium, a growth rate of approximately 2 percent per year. Individual and corporation income taxes are two of the primary revenue sources responsible for the increase. The oil and natural gas production tax also plays a large role in the increased revenues for the 2005 and 2007 biennia. The outlook for these three sources is critical in determining the fiscal status for the 2007 biennium.

Individual income tax is expected to increase by about 2 percent per year during the 2007 biennium, while corporation income taxes are expected to increase by nearly 34 percent. The steady growth in individual income tax is consistent with past projections and results primarily from increased Montana wages and salaries and changes in federal tax statutes. Corporation income tax will continue to show recovery from the 2001 recession although revenues are not expected to increase in FY 2005 because of significant refunds.

The improved economic climate in the U.S. is a large factor in the improved state revenue picture. Oil and gas production revenues are expected to increase $3 million dollars over the 2005 biennium, which was up dramatically from the 2003 biennium. This projection reflects the recent record high oil prices with the expectation that oil prices will remain at unprecedented levels during the 2007 biennium. Interest rates are also expected to increase from the present level. Increased interest rates affect many state revenue sources. In the general fund, treasury cash account interest is expected to increase from $14.8 million in the 2005 biennium to $24.1 million in the 2007 biennium, representing a growth of over 27 percent per year. Positive economic conditions have also affected many of the other revenue sources, which are expected to remain stable or continue past trends during the 2007 biennium.

Expenditures

The projections for the 2007 biennium show that the costs of present law budget would be a base budget of about $2.55 billion plus adjustments of $200.0 million, for total present law disbursements of $2.5 billion. The major factors causing the $200.0 million in adjustments are summarized below.

2005 Biennium Known Supplemental Appropriations

Three supplemental requests totaling $7.4 million are very certain at this time, and are included in the present law adjustments, Table 1.

- Judiciary – District Court Assumption/Unfit to Proceed – While the exact amount is still unclear, the Judiciary will request a supplemental for additional costs of district court assumption of

approximately $5.8 million. Total 2005 biennium costs are expected to exceed the appropriation by $6.8 million, but the Judiciary utilized about $1.0 million of 2003 biennium carryover funds. The Judiciary will also request a supplemental, currently estimated at between $800,000 and $900,000, to pay costs associated with district court "unfit to proceed" evaluations performed at Montana State Hospital (MSH) in the Department of Public Health and Human Services (DPHHS). However, a like amount will be deposited to the general fund.

- Justice – Major Litigation/MHP Pension Trust Fund – The Department of Justice will seek a supplemental appropriation of $200,000 for costs associated with major litigation.[2] The department will also request a supplemental to allow deposit of $1.25 per vehicle fee for the Montana Highway Patrol pension trust fund as required by law. Sufficient authority was not requested in HB 2 to allow this transfer. There will be no impact to the general fund, as the $363,762 supplemental was already assumed in the level of transfers anticipated from the general fund.
- Administration – Workers' Compensation Payback – The Department of Administration will likely request a supplemental this fiscal year to pay back the federal government for its share of the workers' compensation fund balance transferred to the general fund in the 2003 and 2005 biennia. Current estimates are $225,000.

It is emphasized that these supplemental projections are included because they are very likely to occur based on best available information. There are additional areas with existing cost over-run projections, including $3.0 million in the Department of Corrections, that may result in additional supplemental requests. These issues are not included in the projections but are discussed under "Significant Issues Not Included in 2007 Biennium Projections", page 12.

Public Schools

Present law general fund Base aid to school districts and HB 124 block grants to school districts in the 2007 biennium will increase by $15.9 million when compared to the amount spent in FY 2004 doubled. This increase is made up of the following components:

1) decrease in state spending from all accounts (general fund and guarantee account) of $11.0 million due to enrollment declines;
2) increase (statutory) in state spending due to inflation of $30.5 million;
3) decrease in general fund spending due to higher revenues in the guarantee account of $5.5 million; and
4) increase in spending of $1.9 million in HB 124 block grants.

During the 2007 biennium, enrollment is expected to decline an average of 1.2 percent per year. Inflation will average 2.15 percent per year. This number is known since the law requires inflation be calculated as a three year average, lagged three years. Thus, the 2006 inflation number is the average of inflation in 2001, 2002, and 2003.

State spending on Base aid is made out of the guarantee account, which receives revenue from interest and income on state lands, and the general fund. As interest and income increases, less is needed for Base aid out of the general fund. Interest and income is expected to be higher in the 2007 biennium due mainly to higher prices for oil, natural gas, and coal.

[2] As of the writing of this report, there is the possibility that this cost will be paid with federal jobs growth funds, eliminating the need for the supplemental.

HB 124 block grants increase by 0.76 percent per year. This increase accounts for the $1.9 million in higher HB 124 block grants. The remainder of the increase, about $4.0 million, is due to maintenance of higher FY 2005 appropriations for special education and school facility reimbursements in the 2007 biennium.

Public Health

Present law general fund costs in the 2007 biennium are anticipated to increase by a net $86.7 million over the doubled FY 2004 base expenditures. The majority of the increase is due to:

- Changes in the federal match rate for Medicaid, foster care, and child care services that will lower federal contributions and increase state match requirements:
  - A general fund increase due to termination of the temporary 2.95 percent boost in federal match rate for Medicaid services during FY 2004 -- $27.6 million
  - A general fund increase due to annual match rate formula changes -- $24.6 million
- Caseload cost increases, including:
  - Growth in Medicaid service costs due to increases in the number of eligible persons, changes in the service mix and utilization, and inflationary increases in some services such as prescription medications -- $39.4 million
  - Subsidized adoption and foster care caseload increases -- $3.5 million

These increases are partially offset by reductions due primarily to refinancing, and FTE reductions associated with the closure of the Eastmont facility. The caseload estimates are reasonable given the data and trends at this point in time. Historically, caseload estimates have been revised in November and throughout the legislative session as more timely data is available.

Corrections

The Department of Corrections present law general fund is expected to increase by $14.9 million, primarily due to secure care population growth. The department is experiencing increases in population beyond the level anticipated by the 2003 legislature that will likely continue in the 2007 biennium. This report assumes a continuation of the FY 2005 population growth, inflated by 3.5 percent per year.

Higher Education

Projected resident student enrollment for the Montana University System during the 2007 biennium increases at a rate of just over 2 percent annually starting from FY 2003 actual enrollment levels, based upon historical trends and enrollment projections prepared by the university units and the Commissioner of Higher Education. Using the 2005 biennium marginal general fund appropriation per resident FTE student, inflated for annualization of the 2005 biennium pay plan ($1,835), the additional general fund cost due to the projected enrollment increases is $1.6 million in the 2007 biennium.

Projected resident student enrollment for the community colleges during the 2007 biennium increases at a rate of more than 6.5 percent annually from FY 2003 actual enrollment levels, based upon historical trends and enrollment projections prepared by the community colleges and the Commissioner of Higher Education. Using the 2005 biennium general fund appropriation per resident student FTE, inflated for annualization of the 2005 biennium pay plan ($2,631), the additional general fund cost due to the projected enrollment increase is $1.2 million in the 2007 biennium.

This increase is partially offset by a reduction due to the annualization of a $5.5 million biennium general fund appropriation in the 2005 biennium, all of which was expended in fiscal 2004.

Judiciary

In FY 2003, the Supreme Court was given oversight and administration of the state's 22 district courts. Primarily due to an increase in costs associated with an increase in caseload, costs in the 2005 biennium are significantly higher than appropriated by the 2003 legislature, and a supplemental is anticipated in FY 2005 (see "Supplemental Appropriations" above). Total costs in the 2005 biennium are anticipated to be significantly greater than the 2005 biennium appropriation. The additional costs are anticipated to continue in the 2007 biennium. Because the Judiciary was given a biennial appropriation in the 2005 biennium, the expenditures in FY 2004 reflect a portion of this additional cost. Therefore, the district court caseload increase reflected in the table shows only that portion of the additional costs not reflected in the 2004 expenditures. In addition, the Judiciary will now be billed for all costs of the Montana State Hospital (MSH) for evaluations on behalf of the district courts to determine fitness to proceed. A like deposit of revenue to the general fund will offset the yearly MSH evaluations cost of $950,000.

All Other Agencies

This category includes $5.8 million for present law adjustments in agencies of state government not included in other categories. This includes the natural resource agencies and the "administrative" agencies of state government, including the Departments of Administration, Revenue, and Justice.

Other Adjustments

"Other Adjustments" consist of various changes made to the FY 2004 base, including the costs of the 2005 biennium pay plan in the 2007 biennium (see below), annualization of any phased-in or phased-out programs, adjustment of biennial appropriations, elimination of all one-time-only appropriations, and full-funding of FTE upon which personal services funding was based in the 2005 biennium. The vacancy savings rate was maintained at the 2005 biennium HB 2 level of 4 percent for all positions (with limited exceptions). All 2005 biennium across-the-board reductions, with the exception of the FTE reduction, were carried forward. The costs of the 2007 legislative session are also included. Some of the more significant adjustments are explained below.

<u>Pay Plan</u>

The legislature increased monthly insurance contributions by $44 to $410 per month midway through FY 2004 and by another $50 to $460 per month midway through FY 2005. The legislature also increased each employee's hourly salary by $0.25 beginning midway through FY 2005. Therefore, the doubled FY 2004 actual expenditures include only a portion of the insurance increase and none of the salary increase.

The additional annualized general fund cost of the pay plan in the 2007 biennium over the doubled FY 2004 level is $18.7 million. All 2005 biennium pay plan adjustments are carried forward into the 2007 biennium in two parts:

1) Additional costs of the 2005 biennium pay plan in the 2005 biennium over the doubled FY 2004 amount total $5.6 million.
2) All costs to fully fund all pay plan increases in the 2007 biennium over the 2005 biennium level total $13.1 million.

Total general fund pay plan costs in the 2007 biennium are about $23.0 million.

<u>Fixed Costs</u>

"Fixed costs" are charges made to agencies for the costs of the provision of certain centralized functions of state government. Among the fixed costs are information technology services, insurance, various administrative functions such as payroll, motor pool, grounds and maintenance, and accounting system debt service. Fixed costs will rise considerably due primarily to increases in SABHRS and data network costs, and billings for certain global costs.

Vacancy Savings

Vacancy savings is the difference between the cost of fully funding positions for the entire year, and the actual cost of authorized employee positions during that period. While vacancy savings is not considered a present law adjustment, the legislature has consistently applied a vacancy savings at the rate proposed by the Governor. Consequently, a 4 percent vacancy savings is assumed in all present law calculations. The cost of eliminating all vacancy savings is about $21 million over the biennium. Eliminating vacancy savings on all positions that must be filled for 24 hours a day, 7 days of week would cost about $3.5 million general fund.

Inflation

The statutory definition of present law states that inflationary adjustments should be added in preparing a present law budget. However, the budget as presented by the Governor and the budget adopted by the legislature for several biennia has included not only very selective inflation adjustments, but offsetting deflationary adjustments. No estimate is included in this projection for general inflation/deflation adjustments.

Feed Bill

The "feed bill" funds the cost of the legislative sessions and other interim activities. A total $7.0 million is included for those costs in the 2007 biennium (2005 legislative session).

Statutory Appropriations

General fund statutory appropriations increase $18.8 million from the base. The change is due primarily to local government entitlements, property tax reimbursements, economic development, debt service, and retirement contributions.

- For the 2007 biennium, appropriations to local governments authorized by House Bill 124 (2001 session) increase a net $8.0 million due to:
  - Increases in the statutory calculated growth rates
  - A reduction in TIF district payments
- Property tax reimbursements decline by $6.1 million according to the statutory formula
- Payments to state agencies to promote economic development increase $6.4 million, primarily due to the statutory change that pays money to the research and commercialization account through a statutory appropriation rather than a transfer as required in the 2005 biennium
- Costs for servicing debt increase $5.4 million because of higher long-range building debt payments and higher interest payments for TRANS (tax revenue anticipation notes) required to maintain adequate cash flow
- Retirement payments are expected to increase $5.1 million

Transfers

Transfers of money out of the general fund increase $18.8 million from the base. The difference is due primarily to increases in transfers to various state accounts, a decrease in the transfer to the research and commercialization account, increases to the mineral impact account, slow start up of House Bill 564, and one-time transfers in the base year.

- Transfers of general fund to various state accounts increase $13.8 million primarily due to:
  - Transfers to the Department of Highways' non-restricted account that, by statute, did not occur in the base year
  - Transfers of the optional vehicle tax for state parks, the revenue from which the executive deposited in the state special revenue in FY 2004 rather than the general fund
- Transfers to the research and commercialization account decrease $7.3 million due to the statutory change that pays money to the account through a statutory appropriation rather than a transfer as required in the 2005 biennium
- Transfers to the mineral impact account (from which payments are made to eligible counties) increase $13.4 million due to an accounting change that resulted in no transfer in FY 2004 and a larger statutory percentage allocating the revenue to the account
- HB 564 (2003 session) transfers general fund to the Governor's Office to pay off loans that provide training grants to eligible businesses. No grants were made in FY 2004, but the executive anticipates that the program will begin operation in FY 2005 resulting in transfers of $2.3 million in the 2007 biennium
- One-time transfers in DPHHS and proceeds from the sale of the Bozeman armory totaling $3.4 million occurred in FY 2004 and are not expected to continue

LFD RECOMMENDED ALLOWANCES

In addition to the projections in Table 1 that most clearly fit into the statutory definition of present law, the LFD recommends that three other adjustments be made in projecting a more realistic outlook of the funds available for the 2005 legislative session above present law funding. They include leaving an adequate ending fund balance reserve, a reserve for wildfire suppression costs, and a reserve for declared emergencies. Each of these issues is discussed below.

Adequate Ending Fund Balance Reserve

An ending fund balance reserve provides a cushion for variations in actual revenue collections versus projections and for unanticipated expenditures (supplementals/statutory appropriations). Statute requires a minimum ending fund balance reserve of 1 percent of total appropriations, or approximately $27.5 million for a present law budget. When this minimum reserve is included in the projections, it leaves a projected balance of $250.3 million. It would not be good budget management, however, to leave an ending fund balance projection that only meets the minimum, since any negative decline from projections would trigger statutorily required budget balancing action by the executive. Plus, a 1 percent reserve for a biennial budget that is subject to significant fluctuations in revenue estimates and potential supplemental appropriation demands simply does not provide an adequate cushion for unanticipated events.

Recently, the general fund reserve set by the legislature has been above $50 million, or approximately 2 percent of total biennial revenues. While a minimum reserve of 2.5 percent is recommended, it is recognized that in prioritizing a budget, it is difficult to attain. The Legislative Fiscal Division (LFD) suggested minimum adequate ending fund balance reserve is 2 percent, or $57 million. This amount compares to a $46 million ending fund balance reserve adopted by the 2003 legislature for the 2005 biennium. This suggested fund balance reserve is only a guideline and is included to provide a more realistic measure of the excess funds available. Ultimately, the determination of an adequate fund balance reserve is a policy decision of the legislature.

A general fund reserve of at least 2.5 percent of total biennial revenues is considered prudent by national budget experts. A target ending fund balance of 2.5 percent results in a budget reserve of $71.3 million.

Wildfire Suppression Costs

The present law budget projections in Table 1 do not include any estimate for the ever-present cost of wildfire suppression. The legislature traditionally has not budgeted for the costs of fighting wildfires. As a consequence, the ending fund balance reserve must cover all expenses, and the traditional reserve is arguably not adequate to cover the liability fire costs have been in recent biennia. As an example, the over $35 million in fire costs for the current 2005 biennium compared to an original projected reserve of $46 million would have almost certainly required a special session. A special session was avoided by a one-time windfall grant from the federal government that will likely pay all fire costs for the 2005 biennium. Given that the state incurs significant wildfire costs each year, some allowance for these costs must be included in any biennium ending fund balance projection. Although the cost of fighting wildfires can fluctuate significantly from biennium to biennium, a 7 year average, removing the high and low years (FY 2004 and FY 2005, respectively), is just over $7.0 million per year. This number is used in Table 2 ($14.1 million for the biennium) to represent anticipated fire costs in the 2007 biennium. It is emphasized that this is a very conservative number, when considering that the annual costs of wildfire suppression have grown dramatically in recent years. The Legislative Audit Division is currently conducting a performance audit to assess reasons for the dramatic increase in fire suppression costs.

Emergency Fund Appropriation

The legislature has approved a statutory appropriation of $16.5 million general fund each biennium for the Governor to deal with declared disasters or emergencies such as floods, fires, and other natural disasters. Yet even though the authority exists to spend this appropriation under specific emergency circumstances, the legislature has never included any of it in its budget and projected ending fund balance as biennial budgets are set. However, in the 2003 session, the 58th Legislature amended appropriations statute in order to clarify that the legislature must not only budget in good faith for a balanced budget, it must also achieve a positive ending balance at the end of the biennium. This change reinforces the argument that it is sound fiscal policy to include an estimate of expenditures from this appropriation in the projected budget and ending fund balance, just as is done for all other statutory appropriations. From FY 2000 through FY 2003, the average expenditure (excluding fire costs already included in the fire cost average discussed previously) from the emergency appropriation is nearly $400,000 per year ($800,00 per biennium). LFD recommends that a reserve for this average expenditure be included in the projection of the 2007 biennium available funds.

SIGNIFICANT ISSUES NOT INCLUDED IN 2007 BIENNIUM PROJECTIONS

There are other issues with potential material impacts on the 2007 biennium budget for which the fiscal impacts are either uncertain or unknown, and consequently are not included in the projections. Additionally, economic events could produce unanticipated changes in revenue projections. In the event that any of these become reality, there is a potential for impacts to the general fund balance. While not included in the fund balance projections, it is important that the potential impacts be considered in the legislative deliberations to balance the 2007 biennium budget. Where feasible, a cost estimate or potential cost range is provided to assist the reader. Each item is discussed briefly below.

Other Potential 2005 Biennium Cost Over-runs (Supplementals)

In addition to the almost certain supplemental appropriations included in Table 1 in the 2007 biennium projections, based on current information, there are two other areas with potential cost over-runs that could result in FY 2005 supplemental requests. While the amounts are unknown at this time, there is a high likelihood of a request. It is important to be aware of these potential over-runs, but they are not

included because the executive has the option to mitigate these cost over-runs by re-prioritizing or applying cost savings measures.

- The Department of Corrections will likely have a supplemental request in FY 2005 due primarily to increased populations. While the specific amount is unknown, the likely scenario at this point is around $3.0 million. Due to significant cost saving reductions both in the last biennia and in the current biennia in order to stay within budget, it is considered unlikely the executive has many options for further mitigating this cost over-run.
- There is a potential for payouts to outgoing elected officials and their exempt staff for accumulated sick and annual leave balances. While these costs are unknown, they remain a potential supplemental cost in various agencies. The 2001 legislature funded supplemental appropriations for this purpose totaling almost $120,000 general fund.

Fire Costs – The potential for a supplemental for fire costs is a chronic issue. However, if current fire conditions continue, no general fund will be required for fire costs in the 2005 biennium, despite one of the most costly fire seasons ever in FY 2004. This situation is primarily due to a one-time federal grant that allowed all fire costs to be paid from federal funds, and a very low FY 2005 cost due to advantageous weather conditions.

2007 Biennium Pay Plan

As of this writing, no pay plan proposal for the next biennium has been officially discussed, and none is assumed in any of the present law calculations in this report. However, a proposal is likely to be presented to the legislature that exceeds the 2005 biennium pay plan, which provided an increase in health insurance and a nominal salary increase. For purposes of perspective, each 1 percent increase in salary effective November 1 of each year of the biennium would cost about $6.8 million general fund in the 2007 biennium, with an ongoing 2009 biennium cost of about $11.6 million. Each $10 per month insurance increase each year of the biennium, effective on January 1, would cost approximately $1.8 million. A vacancy savings rate of 4 percent is assumed for both calculations.

Litigation: K-12 Funding Adequacy

On April 15th, 2004, the Helena District Court under Judge Sherlock found the Montana system of funding K-12 education unconstitutional. The Sherlock decision found that the state share of school spending was inadequate, and that the current funding formula was not rationally related to educationally relevant factors. In addition, the Sherlock decision found the State has failed to recognize the distinct and unique cultural heritage of American Indians and has shown no commitment in its educational goals to the preservation of their cultural identity.

The Sherlock decision was appealed to the Montana Supreme Court in June 2004. Briefs and cross briefs have been filed, and oral arguments will be heard October 20th. It is anticipated that the Supreme Court will rule before the beginning of session.

If the Supreme Court upholds the Sherlock decision, the legislature may have to do the following:

1) Define the educationally relevant elements of a basic system of free quality public elementary and secondary schools
2) Determine the costs of delivering the resources required by that system
3) Devise a funding formula in law that will determine the state share of school districts' resources

In addition, the legislature may have to revise or augment state and district revenues required to pay for the system.

The amount included in Table 1 of the 2007 biennium present law projection is based on the existing statutory funding formula, which is contested by this lawsuit as being unconstitutional and the level of funding inadequate. While there is no realistic way to estimate the additional cost of funding K-12 education once the legislature has defined quality education and approved a new funding methodology, it is emphasized that the cost increase could be substantial.

Litigation: Highway Patrol Pension Fund

The state is currently in negotiation on litigation brought by certain highway patrol officers for compensation for all lunch hours worked over a 3½ year time period. The action contends that subsistence pay should have included meals, travel, uniform maintenance, and home telephone, and seeks to recalculate overtime, retirement, and benefits accordingly. The class action lawsuit involves over 200 officers, and total state exposure is estimated at between $9.0 and $20.0 million. The Montana Highway Patrol is currently funded with highways state special revenue (general funds had been used for prisoner per diem only, prior to the 2005 biennium), but it is unknown what source of funds would be utilized if the suit results in a monetary judgment.

Litigation: Human Services

The court ordered settlement in the case commonly know as Travis D. requires movement of additional individuals from institutional to community services as well as other developmental disability system ramifications. While DPHHS maintains that the cost impact will be budget neutral, there is a high potential for budgetary impact.

In addition, pending litigation (MAIDS) alleges inadequacy of wages paid by developmental disability community services providers. Along with the direct impact to DPHHS, there is a potential broader impact if the state employee pay plan must be extended to providers under contract with the state.

Litigation: PPL Protested Taxes

Pennsylvania Power and Light (PPL) has protested at least a share of their property taxes every year since tax year 2000. Before the passage of SB 294 in the 2003 session, these taxes were paid into an escrow account and were unavailable for use by the state, local governments, and schools. SB 294 allows the state share of these taxes to be deposited into the general fund. As of the end of FY 2004 a total of $5.6 million in protested taxes was deposited in the general fund. It is expected that an additional $2.6 million will be deposited in FY 2005. The case is before the State Tax Appeal Board, which may rule this winter. It is likely to be appealed in district court no matter which way the Board rules, and may take years to work its way through the courts. There is little risk that the state will lose this money during the 2005 biennium, but if the Board rules against the State it is a distinct possibility in the 2007 biennium.

DPHHS Issues

There are several unique issues in the Department of Public Health and Human Services that could have a significant impact on general fund obligations.

Tobacco Settlement Revenue

The 2003 legislature diverted a portion of the tobacco settlement state special revenue (SB 485) to maintain funding for several programs, including:

- Mental Health Services Plan (MHSP) prescription drug coverage
- Medicaid hospice and home health services

- MIAMI (low birth weight prevention program), poison control hotline, and AIDS drug funding
- Childcare
- Some services and supports provided by the Disability Services Division

Unless tobacco revenue is again diverted for these specific purposes, the legislature will have to find alternative funding if it wishes these services to continue at the 2005 biennium level.

Medicaid Waiver

At the direction of the 2003 legislature, DPHHS undertook a major study of how to redesign Medicaid. The legislature could be asked to appropriate state funding for a proposed Medicaid waiver (part of Medicaid redesign) to:

- Provide mental health drugs to some MHSP beneficiaries and expand services to include a limited physical health benefit
- Expand Medicaid and/or Children's Health Insurance Program (CHIP) coverage to more children and/or parents of low-income children already enrolled in Medicaid or CHIP
- Potentially implement a private/public partnership to expand health insurance coverage to other groups of uninsured Montanans

Federal Medicare Drug Prescription Benefit

Funding and statutory changes could be requested to implement the federal Medicare Prescription Drug Improvement and Modernization Act of 2003 that will impose new costs on states, but also offset some general fund expenditures. Neither the potential costs nor potential savings can be estimated at this time.

Other

Among the other issues with a potentially significant cost impact are Montana State Hospital increases due to higher than anticipated populations, the annualization of costs of new community programs for persons with a mental illness initiated by DPHHS in FY 2005, requests for provider rate increases, and adoption of policy and process changes within the developmental disabilities service system.

Public Defender Study

The interim Law and Justice Committee will propose to the 2005 legislature that the state create a statewide public defender system. The proposal is partly in response to a lawsuit, currently on hold, filed by the American Civil Liberties Union (ACLU), which alleges inconsistent treatment of indigent defendants. A state chief public defender office would be created to provide administration and oversight for all regional offices and contracts with private attorneys. All public defender costs would be assumed by the state, including those of city and municipal courts, with local governments providing funding for a portion of the costs. Of the total $14.1 million estimated cost in the 2007 biennium ($13.5 million ongoing each year), $10.6 million is already incurred by the state, counties, or cities. The remaining $3.5 million ($2.9 million ongoing each year) would be new costs, primarily to support the chief public defender office.

Ballot Initiatives

Two measures are on the ballot in November that will have potential general fund fiscal impact if approved by the voters.

- Constitutional Amendment C-40, which requires the legislature to provide for a noxious weed management trust fund, would have general fund impact only if the legislature determined that it would appropriate general fund to trust fund principal. The trust fund principal would be

inviolate in an amount of $10 million. The fund balance as of September 2004 is about $4.9 million.

- Initiative I-149, which increases tobacco taxes, would result in increased revenues of $44.8 million, $6 million of which would be deposited annually (after FY 2005) to the general fund, assuming that consumption of tobacco products does not drop off significantly. The effective date of the initiative is January 1, 2005. Therefore, there would be increased general fund revenues in FY 2005 of $3 million. Of the $44.8 million, $38.4 million is for new health care funding (through a state special revenue account) and is intended to increase Medicaid services and Medicaid provider rates, and not supplant general fund money "in the trended traditional level of appropriation" for such services. In addition, an estimated $400,000 of the new revenue is earmarked for the long-range building account (in the capital projects fund type).

While there are several other measures on the ballot, none appear to have a direct general fund impact.

Federal Funds

Montana relies heavily on funding from the federal government for a number of state services. Federal funds are used throughout state government, most notably in human services, environmental and wildlife programs, and transportation. Therefore, any change in discretionary federal spending could have a major impact both on individual programs and the state in general. The federal government is currently facing an extremely large budget deficit. Therefore, it is entirely possible that major adjustments will be made as Congress and the President deal with this reality in the post-election environment. As of this writing, only 1 of the 13 appropriations spending bills for the current federal fiscal year has gone through Congress, and further action is not expected until at least mid-November.

Federal Transportation Fund Plan (TEA21)

Congress is debating the level of funding in the new federal transportation bill to replace the current TEA-21. As of the writing of this report, Congress has passed another extension through May, 2005. Therefore, funding will likely still be unknown when the legislature adjourns in April. Depending upon the level of funding ultimately decided, the state could see a significant increase in federal highways funding for various highways related expenditures. Because these funds must be matched, an increase in funding will require an increase in matching funds. Montana currently matches federal funds with state special revenues primarily from gas and diesel taxes, GVW fees, and other minor revenues. This account also funds other transportation related functions of state government, most notably the Montana Highway Patrol. Because current revenues and fund balance are not sufficient to fully match either version of the bill, the legislature may be faced with choices to either increase revenues, reduce other expenditures, or replace funding with general fund if it wishes to maximize federal funds match.

Corporation License Tax

While corporate profitability has undergone a slow recovery since the recession of 2001, there is the potential of continued large refunds in fiscal 2005. Several large state corporations have filed bankruptcy and others experienced large losses as a result of economic events at both the national level and in Montana over the past several years. The LFD has included several refunds, which range in the tens of millions of dollars, in the big picture report estimates. There is uncertainty surrounding the amounts and timing of these refunds, and should the refunds be disallowed, the general fund revenue estimate will be understated.

Personal Property Tax Rate Trigger

The tax rate on business equipment (class 8 property) will remain at 3 percent for tax year 2005. In tax year 2006, the tax rate may decline to 2 percent if prior year Montana wage and salaries, as adjusted for inflation, grow at a rate at least equal to 2.85 percent. If the wage and salary trigger is exceeded, the tax rate would drop to 1 percent in tax year 2007 and zero in tax year 2008. In the last 22 years, growth in Montana wages and salaries adjusted for inflation has exceeded 2.85 percent five times, most recently in calendar 2000. Should this "trigger" be pulled, total property tax revenues would be reduced by approximately $60 million per year at a zero percent rate.

New Proposals and Other Initiatives

In every biennium, the governor requests and the legislature approves increases beyond the present law budget, referred to as "new proposals." In addition, an employee pay plan and various legislative initiatives are considered and approved. In recent biennia, the total cost of such items has ranged from $78 million to $188 million. Since funding for an expanded level budget is not a present law service and is a matter of legislative policy and prioritization, no estimate is included in the 2007 biennium present law projection. In the context of preliminary budget projections, the legislature needs to be aware of the potential, based on historical data, of such requests. Some new proposals, including the pay plan, are discussed separately.

Economic Uncertainty and Revenue Trends

Montana revenues are extremely sensitive to many factors such as corporate profitability, prevailing interest rates, capital gains/losses, and energy prices, and the relative strength in all these sectors implies a period of increased state revenues. U.S. corporate profits have shown respectable growth since the slump experienced in 2001. The Federal Reserve has recently raised interest rates, the S&P 500 is boasting large gains from one year ago, and oil prices have reached a new high of $50 a barrel. All of these indicators are good news from the perspective of state tax receipts. However, there is always a fair amount of uncertainty surrounding future changes in these economic factors.

One economic area of particular concern for the next biennium is the price of oil. As mentioned above, oil for the first time has reached $50 per barrel. The LFD has estimated oil prices for the next biennium at over $32 per barrel. This total compares very favorably, as related to state revenues, to HJR 2 estimates of $22 per barrel in the 2005 biennium. Indications are that the price of oil will remain high for an extended period of time, but should the price drop to previous levels, oil estimates will be overstated.

STRUCTURAL BALANCE

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

As shown in Table 2, the present law excess after reserves is projected to be $205.8 million for the 2007 biennium. Although this excess amount is in stark contrast to previous biennia, it is critical to analyze the structural balance of the general fund account before a conclusion can be drawn about whether additional funds are appropriate for state services and/or tax policy initiatives of an ongoing nature.

For the 2007 biennium, anticipated revenues are expected to exceed present law disbursements by $87.0 million. If future revenues continue to increase at a similar growth rate, the 59th Legislature should have an additional $87.0 million above present law costs for state services and/or tax policy initiatives The remaining balance ($118.8 million) is also available for legislative consideration but should be used only for one-time initiatives if a structural balance is to be maintained. To the extent the 59th Legislature uses any of the $118.8 million for on-going initiatives, it could result in a deficit budget picture for future legislatures.

Table 4 shows a simplified general fund balance sheet for the 2007 biennium and a hypothetical example for the 2009 biennium assuming a 5 percent growth in revenues and disbursements. This table illustrates that if the $118.8 million present law excess is used for one-time initiatives during the 2007 biennium, the 59th Legislature will not be faced with an anticipated deficit, assuming disbursement growth is kept in concert with revenue growth.

Table 4
General Fund Account Balance Statement

Balance Statement Components	Outlook 2007 Biennium Millions	Illustration 5% 2009 Biennium Millions
Beginning Fund Balance	**$175.848**	**$57.008**
Present Law Revenues	2,850.407	2,992.927
Present Law Disbursements	(2,748.482)	(2,885.906)
Emergency/Wildfire Reserve	(14.591)	(15.321)
New Initiatives - Ongoing	(87.334)	(91.701)
New Initiatives - One-Time	(118.840)	0.000
Ending Fund Balance 2 percent of biennium revenue	**$57.008**	**$57.008**

SUMMARY

The 59th Legislature faces a much brighter budget picture than the large deficit facing the 58th Legislature in the 2003 session. The brighter picture is primarily due to strong growth in individual income tax and oil and gas tax revenues. The projected present law ending general fund balance for the 2007 biennium is $277.8 million without reserves, and is reduced to $205.9 million when allowing for a 2 percent ending fund balance reserve and allowances for fire suppression and emergency fund costs. This balance leaves the 59th legislature with more flexibility when prioritizing a present law budget and more opportunities when considering new initiatives, including both new programs and tax policy changes. It is important to keep in mind, however, that there are a number of issues, listed in Table 3 and discussed beginning on page 12, with potential material impacts on the 2007 biennium budget that are not included in the projections. The fate of these potential issues could significantly reduce, or eliminate, the funds available for the 2007 budget prioritization process. In addition, the legislature needs to keep in mind the objective of maintaining a structurally balanced general fund. If structural balance is to be achieved, it is important to note that not all of the projected balance would be available for initiatives and funding of an ongoing nature. Only $87.0 million would be available for ongoing expenditures, while $118.8 million should either be held in reserve or used for one-time expenditures.