Major Issues Facing the Legislature

This chapter provides a discussion of a number of budget issues that are not described in any detail elsewhere in this volume. These major issues are divided into two categories: 1) issues that related to the executive budget, and 2) other issues of which the legislature needs to be aware. Those issues are listed below and discussed further in the pages that follow.

Executive Budget – Other LFD Issues

- Lack of Measurable Performance Indicators
- Structural Balance
- Post-Session – What Happens if Revenues Fall?
- Pay Plan - Issues
- Undeveloped Budget Proposals

Other Fiscal Issues for Legislative Consideration

- Montana State Fund “Old Fund” Liability
- Pending Lawsuits
    - K-12 Education
    - State Fund
- Wildfire Funding
- Long-Term Stability of the General Fund
- Fund Balance Adequacy/Reserves
- Highway State Special Revenue Account Decline in Working Capital Balance
- Pension Plans Unfunded Liability

LACK OF MEASURABLE PERFORMANCE INDICATORS

WHAT IS PERFORMANCE MEASUREMENT?

Performance measurement is a best-practice tool used widely across the nation by governments and other organizations to answer a number of very basic questions about the how and why of what the government/organization does, and the amount of resources necessary to make it happen. By using performance measurement in government, taxpayer dollars are better assured of being used in the most efficient way for the highest priorities.

The center mechanism for this process is to articulate clear goals, and provide objectives for determining whether things are moving in the right direction in an acceptable period of time and at an acceptable resource level to accomplish the goal. Objectives are not simply a list of tasks performed by the program. Rather, they articulate measureable outcomes expected, such as the percentage reduction in the number of teenage pregnancies over the 2011 biennium or the percentage increase in the number of students who graduate from high school in the next two years.

WHY IS PERFORMANCE MEASUREMENT IMPORTANT?

Performance measurement, when fully implemented, will be a quantum leap forward in the legislative budget process. With well crafted goals and objectives, it allows the legislature to answer a number of questions basic to its constitutional duty to fund state government.

- Why does government spend money? What is it trying to accomplish (what are its goals)? Is it accomplishing its goals? How does it determine whether the goals are being met?
- Put another way, are people better off because of the expenditure of state funds? Are enough people better off in an acceptable period of time to justify the expenditure?
- In a world of critical priority setting, which programs are meeting the most critical goals in the most efficient manner? What resources do programs providing high priority services need to do the job most efficiently and successfully?
- What information is needed to make this determination?

It is to help in answering these questions that state statute requires that the executive budget include goals and objectives for each program, and that the goals and objectives include "…sufficient specific information and quantifiable information to enable the legislature to formulate an appropriations policy regarding the agency and its programs and to allow a determination, at some future date, on whether the agency has succeeded in attaining its goals and objectives."

CONSISTENTLY IDENTIFIED ISSUES

LFD staff, as part of the analysis of the executive budget, also examined the goals and objectives submitted by each program to aid the legislature in establishing appropriations. While all programs submitted goals in some fashion, there were a number of consistently observed issues that reduce their usefulness in allowing the legislature to establish appropriations policy, including:

- Goals were presented, but they had limited applicability to the specific purpose of the program
- Objectives for meeting the goals were not presented, which means that there is no way of determining how the program would achieve the goal or whether the program is even moving in the right direction
- Objectives were presented, but they were simply lists of tasks that would be performed, which did not necessarily equate to achievement of goals. For example, one program stated its goal was to operate correctional programs that emphasize offender accountability and rehabilitation, staff professionalism and responsibility, public safety, and efficient use of taxpayer dollars. Its objectives in meeting the goals were to maintain accurate position descriptions and complete monthly inmate evaluations that are consistent with the position descriptions. As written, the objectives were simply tasks performed, and could not be used to indicate whether the goal of operating correctional programs that emphasize offender accountability and rehabilitation, staff professionalism and responsibility, public safety, and efficient use of taxpayer dollars was being met

LACK OF MEASURABLE OBJECTIVES

The most common issue raised in the analysis, and the one that is the most challenging to the legislature in determining success and adequacy of funding levels, was that most objectives did not allow for the measurement of progress or identification and correction of challenges.

During the 2009 interim, the Legislative Finance Committee (LFC) partnered with agencies to track several goals and objectives throughout state government. The following comparison between the objectives discussed with the LFC by the Public Health and Safety Division of the Department of Public Health and Human Services (DPHHS) and the objectives submitted in the budget serves as an illustration of the necessity and value of providing measurable objectives. The goals and objectives used in this example are only a sample of the broader range identified and discussed by the division.

Example:

State and federal governments place a high priority on smoking cessation programs, not only for the direct benefit to individuals, but because of the significant expenditures made by governments to treat persons with smoking-related conditions and because of lost productivity. Therefore, the efficacy of expenditures to desired outcomes is of high importance, and the federal government requires states to extensively report on a number of benchmarks. The following goals encompass this effort.

Goal: Reduce the burden of chronic disease, injury, and trauma in Montana

Objectives Discussed with LFC

- By June 2009, decrease the proportion of high school student who report smoking cigarettes in the past 30 days from 20 percent (2007) to 18 percent
- By June 2009, decrease the proportion of high school students who report spit tobacco use in the past 30 days from 13 percent (2007) to 11 percent

Goal: Improve the health of Montanans to the highest level possible (the only goal submitted for the entire division)

Objectives Included in Budget Submission

- Continuously reduce the proportion of high school students smoking cigarettes in the last 30 days
- Continuously reduce the proportion of adults currently smoking

With the first set of objectives, specific, measurable, time bound objectives are included that allow the program to gauge progress and success, and would alert both the program and the legislature when efforts need to be adjusted. Note also that the objectives are not simply a list of tasks the program will do, but actual outcomes of those efforts.

The second set of objectives provides no means of determining what constitutes success. For example, does spending several million dollars for a minor reduction in the proportion of smoking constitute success? How does the program or the legislature determine whether the expenditure of funds is effective and efficient, or whether those funds could be more effectively used elsewhere?

As the legislature examines each program's budget, it may wish to discuss with the program what goals it is attempting to further, and how the program and the legislature can determine what successes are being achieved, what challenges exist, and how the appropriation process can be used to aid in achievement of success.

STRUCTURAL BALANCE

GENERAL FUND

Structural balance refers to the balancing of on-going expenditures with on-going revenues. If revenues equal or exceed expenditures, then structural balance is achieved for the short-term. If expenditures exceed revenues, then structural imbalance occurs. Figure 1 shows historical data for both revenues and expenditures since FY 2000. It should be noted that the data for FY 2000 through 2009 represent total revenues and expenditures and have not been adjusted to reflect "on-going" amounts. Since this type of categorization has not been maintained on a historical basis, the only on-going amounts shown in Figure 1 are for FY 2010 and 2011.

Total general fund revenues exceeded total expenditures for 6 of the past 9 years from 2000 to 2008 (see Figures 1 and 2). In the mid- to late-1990's, the legislature placed a concentrated effort on achieving structural balance and made significant progress, reaching a sizable positive balance in FY 2000. It should be noted that during this time, Montana, as well as other states, were reaping the benefits of an information technology boom and the significant increase in individual income taxes due to capital gains income. The pendulum, however, shifted the other way beginning in FY 2001, where revenues were slightly above expenditures. The unprecedented revenue shortfall in the 2003 biennium intensified the imbalance heading into the 2005 biennium.

Figure 1

General Fund Structural Balance

Figures in Millions

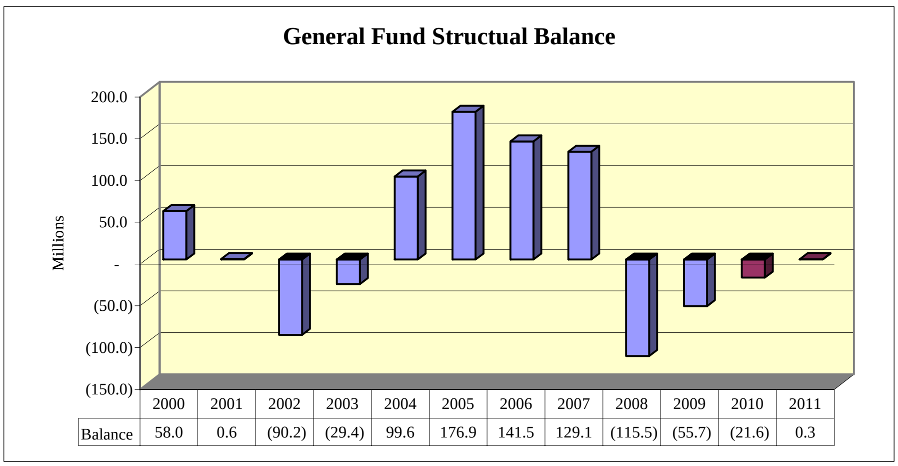
		End. Fund Balance	Yearly Adjustments	Yearly Revenue	Yearly Disburse		Yearly Sur./(Def.)	Biennial Revenue	Biennial Disburse	Biennial Sur./(Def.)
A	2000	$176.000	$8.287	$1,163.638	$1,105.599		$58.039			
A	2001	172.897	(3.637)	1,269.472	1,268.938		0.534	2,433.110	2,374.537	58.573
A	2002	81.316	(1.391)	1,265.713	1,355.903		(90.190)			
A	2003	43.065	(8.805)	1,246.381	1,275.827		(29.446)	2,512.094	2,631.730	(119.636)
A	2004	132.873	(9.719)	1,381.565	1,282.038		99.527			
A	2005	299.792	(10.010)	1,530.949	1,354.020		176.929	2,912.514	2,636.058	276.456
A	2006	422.209	(19.010)	1,708.166	1,566.739		141.427			
A	2007	543.541	(7.767)	1,829.872	1,700.773		129.099	3,538.038	3,267.512	270.526
A	2008	437.677	9.641	1,953.540	2,069.045		(115.505)			
F	2009	387.148	5.100	1,885.741	1,941.370		(55.629)	3,839.281	4,010.415	(171.134)
F	2010	363.552	(1.934)	1,816.452	1,838.114	*	(21.662)			
F	2011	374.345	10.481	1,893.490	1,893.178	*	0.312	3,709.942	3,731.292	(21.350)

* Executive Budget On-going Proposals

Historically, the legislature has faced the ever-present difficulty of holding down budget growth when confronted with double-digit growth in correction costs, increased human service demands, and pressures for increased education funding. The 2007 legislature enacted a structurally balance budget, but as Figure 1 shows, it is projected to end the 2009 biennium with a structural imbalance. Again, this is because the data shown for the 2009 biennium reflects total revenues and expenditures and has not been adjusted to show on-going amounts. During the 2009 session, the legislature will face a proposed biennial budget that is structurally imbalanced for the 2011 biennium. But as Figure 1 portrays, structural balance is achieved for FY 2011.

Figure 2 shows that the anticipated revenues as projected by the LFD are $21.4 million below on-going expenditures in the executive budget proposal for the 2011 biennium. Further, the simple assessment of structural balance as matching on-going revenues to on-going expenditures, while useful to ensure short-term sustainability, is not a good measure of long-term sustainability. Issues such as the likely reduction in federal fund support (due to federal action to reduce a huge deficit) or considerations of future funding pressures (such as the cost of an aging population or the reversal of declining school populations) require more in-depth analysis than is used in the current calculation of structural balance. These issues are discussed in more detail in an assessment of longer term sustainability of the general fund, beginning on page 106 of this volume.

Figure 2



EXPENDITURE PROPOSALS

There are several ways in which structural balance can be adversely impacted in subsequent biennia, on the expenditure side:

- Expanded expenditure growth, as is common with caseload driven entitlement programs such as Medicaid, can adversely impact structural balance
- Realization of delayed implementation of expenditures. Annualization of the 2011 biennium pay plan, which delay implementation until mid-year, will require additional funding in the 2013 biennium
- Growth in services arising from expansions in such programs as Medicaid or from increases in prisoner populations supervised by the Department of Corrections. For any increase in annual expenditures, there must be on-going revenue with which to fund it. In order to attain or maintain a structural balance, annual revenue growth must equal or exceed expenditure growth

- Growth in services arising from known demographic or other economic changes, such as the cost of an aging population

General Fund - Conclusion

From a short-term view point of assessing structural balance related to matching on-going revenues with on-going expenditures, the executive budget for the 2011 biennium is structural imbalanced. Reviewing each fiscal year individually, there is a structural imbalance in FY 2010 of $21.7 million but a structural balance of $0.3 million in FY 2011. Achieving long-term sustainability requires a more in-depth assessment and is a significant policy issue the legislature should address in order to make the budget process less problematic for both the legislative and executive branches in subsequent biennia. See the discussion of sustainability on page 106 of this volume.

Other Funds

In addition to issues of structural balance in the general fund, there are issues of structural balance in some of the state special revenue accounts included in the executive budget. A number of functions of state government are funded from accounts that receive their income from dedicated taxes and fees. One example is the highway special revenue account, which funds highway construction and maintenance and safety related costs. This fund is in a chronic state of structural imbalance due to an inelastic revenue source and inflationary construction costs. While the highways account is structurally balanced through the 2009 biennium, it is only because highway projects have been cut back to fully meet federal match opportunities, but reduce state funded projects. These are serious questions of long-term sustainability. In other parts of the executive budget, the legislature will find instances in which the executive has proposed expenditures that exceed revenue. By budgeting from these accounts at expenditure levels that exceed on-going revenues, the executive draws down the fund balance and creates program expenditure levels that cannot be sustained. Therefore, future legislatures would be faced with reducing program expenditure levels or increasing revenue. In agency sections of the Legislative Budget Analysis, staff has identified those instances in which expenditures from an account exceed anticipated on-going revenues.

POST SESSION – WHAT HAPPENS IF REVENUES FALL?

Budgeting is not an exact science and requires a significant amount of economic and budgetary forecasting. Since Montana adopts a budget on a biennial basis, numerous forecasts must be prepared almost three years in advance. During this period of economic uncertainty, it is likely that the budget outlook for the 2011 biennium could vary widely from month to month. To provide a perspective, every one percent change in revenues amounts to approximately $36 to $37 million for the biennium. A ten percent downturn in revenues would be close to $360 to $370 million for the biennium, equivalent to the entire Department of Corrections general fund biennial budget.

What happens if revenues fall after the legislature adjourns? This question cannot be answered without knowing the policy issue of an ending fund balance. If the legislature adjourns with a minimal ending fund balance (about $50 million), then MCA 17-7-140 provides statutory guidelines to the executive in the event of a revenue shortfall. In essence, this section of law requires the executive to submit a "reduction in spending plan" to the Legislative Finance Committee (LFC) prior to implementing reductions in spending. The LFC, after receipt of this plan, may submit recommendations to the executive prior to the executive implementing spending reductions. If spending reductions of more than ten percent are required to maintain fiscal solvency, then the Governor would be obligated to call a special legislative session to address the fiscal conditions.

If the legislature adjourns with a higher projected ending fund balance (executive recommends $295 million), then the excess balance would be used in the event of a revenue downturn. There are policy issues relevant to budgeting for a higher ending fund balance. First, using an ending fund balance in the advent of a revenue shortfall does not provide the legislature the opportunity to re-prioritize spending during a period of declining revenues. Today's priorities may not be the same six months from now. Second, using the ending fund balance for on-going programs could create a structural imbalance that could not be addressed until the next legislative session. This may limit the options available to the next legislature to address the fiscal imbalance. Third, if the revenue decline is longer term (beyond the biennium), then the utilization of an ending fund balance is not a prudent fiscal policy. This is merely a policy to "get you through the biennium". And finally, how high should the ending fund balance be? As mentioned above, a 10 percent decline in revenues for the biennium would be in the range of $360 to $370 million. Even the executive's proposed ending balance would not be adequate in that case. If the budgeted ending fund balance is not adequate to maintain solvency, then the provisions delineated in MCA 17-7-140 would be required.

The legislature may want to consider their involvement in the development of fiscal policies in the advent of a revenue shortfall. As discussed above, the existence of an unrestricted large fund balance reserve leaves the Governor much flexibility in determining a response to a revenue shortfall without calling the legislature into special session. Options to consider might include the setting aside a portion of the projected fund reserve into a rainy day fund or other restricted category that would require legislative action to access the funds.

PAY PLAN - ISSUES

The Governor has allocated $10.4 million in FY 2010 and $8.3 million in FY 2011 (biennial $18.7 million) general fund for a pay plan in the 2010 biennium. (Please note that the total is for the pay plan received December 18, and does not tie precisely to the Governor's December 15 balance sheet) There are two primary provisions of the pay plan:

- An increase in insurance of $53 per month (8.5 percent) in FY 2010 and a further $54 per month (8.0 percent) in FY 2011 to $679 per month in FY 2010 and $733 per month in FY 2011
- A one-time biennial payment of $450 for each 1.0 FTE and $225 for each 0.50 to 0.99 FTE who makes less than $45,000. The payment would not impact the employee's salary and would not be included in the base budget

The executive also includes $4.0 million general fund and $3.0 million other funds for a contingency for agencies that cannot meet the higher proposed vacancy savings rate of 7 percent, and $75,000 for training.

The following figure shows the total pay plan each year.

Figure 3

Governor's Proposed Pay Plan, by Year and Recipient
2011 Biennium

	-- FY 2010 --			-- FY 2011 --			-- 2011 Biennium --		
Entity	General Fund	Other Funds	Total Funds	General Fund	Other Funds	Total Funds	General Fund	Other Funds	Total Funds
					--- On-going ---				
Insurance Increase									
Consumer Counsel	$0	$1,908	$1,908	$0	$5,760	$5,760	$0	$7,668	$7,668
Legislative Branch	41,022	0	41,022	123,840	0	123,840	164,862	0	164,862
Judicial Branch	133,322	6,599	139,921	408,240	19,920	428,160	541,562	26,519	568,081
Executive Branch	1,629,967	2,102,554	3,732,521	4,931,731	6,353,518	11,285,249	6,561,698	8,456,072	15,017,770
University System	1,429,997	54,696	1,484,693	2,885,088	110,424	2,995,512	4,315,085	165,120	4,480,205
Subtotal	$3,234,308	$2,165,757	$5,400,065	$8,348,899	$6,489,622	$14,838,521	$11,583,207	$8,655,379	$20,238,586
					--- OTO ---				
Lump-Sum Payment									
Consumer Counsel	$0	$527	$527	$0	$0	$0	$0	$527	$527
Legislative Branch	19,744	0	19,744	0	0	0	19,744	0	19,744
Judicial Branch	124,649	3,028	127,677	0	0	0	124,649	3,028	127,677
Executive Branch	1,838,668	2,146,937	3,985,605	0	0	0	1,838,668	2,146,937	3,985,605
University System	1,082,390	29,485	1,111,875	0	0	0	1,082,390	29,485	1,111,875
Subtotal	$3,065,451	$2,179,977	$5,245,428	$0	$0	$0	$3,065,451	$2,179,977	$5,245,428
Training Allowance*	75,000	0	75,000	0	0	0	75,000	0	75,000
Personal Services Contingency*	4,000,000	3,000,000	7,000,000	0	0	0	4,000,000	3,000,000	7,000,000
Total	$10,374,759	$7,345,734	$17,720,493	$8,348,899	$6,489,622	$14,838,521	$18,723,658	$13,835,356	$32,559,014

*Biennial appropriations

The following shows the biennial amount, by funding source and component.

Figure 4

Proposed Executive Pay Plan by Component
2011 Biennium

	--- 2011 Biennium ---				
Component	General Fund	State Special	Federal	Proprietary	Total Funds
Insurance Increase	11,583,207	5,201,352	3,311,872	142,155	20,238,586
Lump-Sum Payment	3,065,451	1,347,925	794,572	37,480	5,245,428
Training	75,000	0	0	0	75,000
Personal Services Contingency**	4,000,000	1,781,472	1,169,215	49,313	7,000,000
Total	$18,723,658	$8,330,749	$5,275,659	$228,948	$32,559,014

*Does not include non-appropriated university funds or proprietary funds.
**The contingency is proposed by "general fund" and "other funds". Table is an extrapolation of funding for the other components.

LFD COMMENT

What Personal Services Goals is the Governor Addressing?

There are a number of potential goals for any pay plan:

- Maintenance or increase of purchasing power through one or both of two means:
  - Inflationary adjustments to salaries
  - Increase in benefits to meet rising medical and other benefits costs
- Attempts to recruit and/or retain qualified employees throughout state government, which is generally addressed through such measures as:
  - Adherence or regular movement to market salaries
  - Opportunities for career path advancement within and among job descriptions
  - Special allowance for difficult to hire/recruit positions
  - Longevity adjustments for continued service
- Statewide compensation equity among and within agencies for like work, the evidence for which is lack of a wide discrepancy in salaries as a percent of market (both experienced and starting positions), and similar movement to market over time for similar positions

Health Insurance and Salary Adjustment

The Governor has addressed maintenance of some portion of purchasing power in the provision of health insurance. According to division officials, employees paying a dependent premium will see an increase above the amount provided in the pay plan of $23 per month in 2010 and a further $26 per month in 2011. Officials indicate that this amount uses a best case assumption on prescription and medical cost trends, and the minimum reserve level recommended by the actuary. Consequently, employees would see a reduction in purchasing power. The one-time payment is designed in some measure to assist lower paid employees to cover increased costs of health insurance not covered by the monthly increase.

LFD COMMENT (CONT.)

Other Factors

In examining the lack of either a standard increase in base salary or a factor that addresses disparity to market or to similar positions in the Governor's proposal, there are a number of factors to keep in mind.

- General inflation (consumer price index – CPI) is expected to increase by about 1.7 percent in FY 2010 and 2.2 percent in FY 2011 (please note that medical inflation is a portion of this increase). Since inflation is expected and no salary increases are provided, state employees will lose some purchasing power under the Governor's proposal. However, the increase in benefits each month equates to a maintenance of most purchasing power for medical expenses, although some co-pays and deductibles will likely increase for employees with dependents
- Although in many instances the gap appears to be narrowing, information provided by agencies continues to show a discrepancy among agencies in percent of market for both starting and experienced employees, although no agency (with the exception of the Judiciary and the Office of the Public Defender), is below 80 percent in total. In addition, any advances to market must be done internally within the agency outside of the pay plan funding if the Governor's pay plan does not include a component that addresses salary progression. This has two impacts:
    - Agencies with fewer resources will be at both an actual and competitive disadvantage to agencies that have more available resources
    - A continuing larger and larger share of personal services adjustments will continue to be made outside of the pay plan and therefore outside of direct appropriation by the legislature

Agencies have used vacancy savings to make market and other salary adjustments. The executive proposal to increase the vacancy savings rate on most positions means that agencies will have less funding available to make these adjustments.

LFD COMMENT

Lump-Sum Payment Addresses Only Purchasing Power Goal

The lump-sum payment of $450 to full-time employees making less than $45,000 per year in base salary does not appear to have a goal other than to temporarily increase purchasing power. For example, anyone making the income threshold or less would get the increase, regardless of how near or far they were from the market salary for their position. Also, the eligibility for the increase is determined based on base salary, and does not consider whether the employee has longevity (additional salary due to length of service). Therefore, an employee doing the exact same job for the exact same base salary but making several percentage points above the base due to longevity would receive the same dollar increase.

LFD ISSUE

Active Employees Subsidize Premium Costs of Retired Employees

Current statute allows retired state employees to continue coverage under the state plan by paying for their premiums. Currently, retirees' premiums are set at the same level as active employees, even though their costs are higher. Therefore, active employees and the state share funded by the legislature subsidize these costs (the Montana University System, which has an independent, self-funded insurance plan, charges retirees at a higher rate than active, although they still are subsidized). While the subsidy for retirees over 65 and eligible for Medicare is low, the subsidy for retirees under 65 years of age can range from $200 to $300 per month per retiree.

The legislature may wish to articulate its policy on the provision of health insurance to current and retired employees, and whether it wishes to continue to subsidize retirees or use a portion of the funds saved by requiring retirees to pay a higher premium to reduce costs or increase other compensation for active employees.

Option
The 2009 legislature will discuss whether to fund a comprehensive study of the impacts on state revenues and expenditures of an aging state population, including an aging state workforce. The legislature may wish to incorporate this issue into that discussion, and direct the study to include a discussion of pay plan issues.

For a further discussion of all issues related to the state employee health plan, see the Health Care and Benefits Division discussion beginning on page A-212 of Volume 3 of the 2011 Biennium Budget Analysis.

LFD ISSUE

Integration of Pay Plan and Budgeting Discussions

Personal services is the single largest expenditure for most agencies, as most agencies directly provide services through the efforts of those employees. Consequently, issues pertaining to personal services and to their adequacy to meet certain goals of state government take on a high importance. The size and character of any pay plan is an important component in addressing those issues. Given its size and importance, the pay plan discussion should be integrated with other budgeting policy decisions of the legislature. Two examples are given:

- The adequacy and policy goals for the rates to fund the state employee health plan are discussed by the Joint Appropriations Subcommittee for General Government when it reviews the budget for the Health Care and Benefits Division of the Department of Administration, which operates the plan, in HB 2. However, this determination and issue discussion is not woven into discussion of the pay plan

- A large number of issues within state agencies pertain to the ability of agencies to recruit and retain qualified personnel to do the job the legislature expects. Salary and benefits, particularly in relation to competition with the private sector or others, are a significant part of those issues. Therefore, any discussion of the policy behind the pay plan, such as whether funds are used to provide an across-the-board increase or target certain professions, to allow flexibility in provision of market and other adjustments, to subsidize retirees or use those funds to recruit and retain active employees, or any number of other issues, should be discussed in tandem.

Option

The legislature may wish to expand the discussion of any pay plan proposal to include the broader goals the pay plan is designed to address, and how success of the pay plan in furthering those goals will be measured. As a part of this discussion, the legislature may wish to articulate specific reporting requirements on recruitment and retention issues and have the Department of Administration report to the Legislative Finance Committee and any other appropriate interim committees during the interim.

UNDEVELOPED BUDGET PROPOSALS

Under current statute (5-12-302, MCA), the duties of the legislative fiscal analyst (LFA) are specified in detail. One of those requirements is to "analyze the executive budget and budget requests of selected state agencies and institutions, including proposals for the construction of capital improvements". Statute (Title 17, Chapter 7, MCA) also dictates the level of detail required to be submitted as the executive budget The executive budget as submitted on November 15 and subsequently revised on December 15, 2008, contained several fiscal policy proposals that did not contain adequate details for the LFA to perform its statutory duty. For example, the executive budget proposes to mitigate the effects of property tax reappraisal. This is a significant tax policy initiative that has been advocated by this administration for most of the interim. The general fund balance sheet, as prepared by the executive, contained an estimate for "property tax mitigation" but did not contain any explanatory details on how this mitigation effort would be accomplished. Property classes three, four, and ten will all be impacted significantly by reappraisal cycle, but the executive budget does not explain their proposed tax policy dealing with this issue. Without explanatory details, the LFA can not perform its statutory duty and the legislature is hampered due to the lack of independent fiscal analysis by staff.

The executive budget also proposes to issue $21 million in bonds to purchase additional school trust land. The only details provided in the executive budget are the anticipated debt service payments to service the debt. It does not specify what type of land would be purchased, when the purchases would be made, what type of income would be generated from the lands purchased, how the lands purchased would be categorized as school lands, and other details necessary to prepare a cost benefit analysis. Again, without explanatory details, the LFD cannot perform its statutory duty and the legislature is hampered by the lack of fiscal analysis by staff.

There are other fiscal policy proposals that are contained in the executive budget that do not contain adequate explanatory details. In some instances, staff can refer to draft legislation that may assist in preparing an analysis provided the draft legislation is available. In some cases, the draft legislation does not conform to the numeric references in the executive budget. In these cases, staff is faced with the conundrum of preparing a budget analysis that is pegged either to the printed executive budget or the draft legislation, and trying to determine which is the executive budget proposal.

The above are examples that staff encounter when performing the statutory duties as outlined in MCA 5-12-302(3). The legislature may want to consider statutory revisions that will enhance the submittal of budgetary details by the executive. One option is to clarify the level of detail required to be submitted with the executive budget. Another possible solution would be to accelerate the budget submittal dates so legislative staff would have adequate time to request additional budget details if the information submitted is inadequate. When major revisions to the executive budget are submitted on December 15, it is impossible for staff to ferret out details and have a complete analysis done prior to the convening of the legislature.

MONTANA STATE FUND "OLD FUND" LIABILITY

The Montana State Fund provides Montana employers with an option for workers' compensation and occupational disease insurance. Prior to 1990 workers' compensation experienced significant liabilities. The legislature restructured the state fund, and separated state fund liabilities between claims occurring before July 1, 1990 and claims occurring on or after that date. Funds relating to claims prior to July 1, 1990 are referred to as "Old Fund" and those on or after as "New Fund".

Statutes require that in any fiscal year where claims for injuries from accidents occurring before July 1, 1990 (Old Fund) are not adequately funded, the funds must be transferred from the general fund. As of June 30, 2008 the estimated liabilities exceeded assets by $36.5 million. At this time, the Old Fund is projected to have sufficient invested assets to meet its obligations until FY 2011, when an estimated $760,317 general fund would be needed to offset this shortfall. In FY 2012, the cost is estimated to be $8.0 million. As discussed below, two cases currently in the courts may affect both the amount of the liability and how long the fund has sufficient assets to meet its obligations.

The Governor's 2011 biennium budget proposal does not include any provision for transfer of general fund to cover a shortfall in the Old Fund. As stated above, the fund could need a general fund transfusion in FY 2011 to meet its estimated liabilities. It could either be dealt with by a transfer by the 2011 Legislature or by the 2009 Legislature.

PENDING LAWSUITS

STATE FUND

As discussed above, the state fund "Old Fund" projected shortfall is $36.5 million. In addition, two court cases brought against the Montana State Fund (MSF) may increase the general fund liability in the Old Fund by up to $117.9 million.

- *Satterlee* challenges the constitutionality of terminating permanent total disability and rehabilitation benefits when a claimant receives or becomes eligible to receive full Social Security retirement benefits or an alternative to that plan. A Montana Workers' Compensation Court judge ruled in favor of the respondents/insurers (including Montana State Fund) in December 2005. A request for reconsideration of the case was denied by the Montana Workers' Compensation Court. The case was appealed by the plaintiffs to the Montana Supreme Court. On December 11, 2008 the Montana Supreme Court issued an order dismissing *Satterlee* without prejudice as two constitutional issues remained for ruling on by the lower court. The Workers' Compensation Court ruled in MSF's favor on both issues. On July 1, 2008 *Satterlee* again appealed the decisions to the Montana Supreme Court. The potential estimated benefit costs for non-settled permanent total disability claims, if the statute is ultimately held to be unconstitutional and to apply retroactively, is between $93 and $116 million for the Old Fund.

- A second lawsuit, *Quick*, requests retroactive and future domiciliary care benefits for a claimant. The case is on appeal to the Montana Supreme Court. Should the Montana Supreme Court reverse the lower court decision and award retroactive domiciliary care prior to February 1, 2007, the potential estimated benefit costs are $1.9 million.

K-12 LAWSUIT

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

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

The 2005 legislature passed and the governor signed SB 152 defining a basic system of free quality schools, and created the Quality Schools Interim Committee. In December 2005, before QSIC had finalized a funding formula, the Governor called a special session of the legislature and four new components were added to the K-12 funding formula, costing the state approximately $35.0 million for fiscal 2007 in ongoing state support and $33.5 million in one-time only funding. Subsequently in 2007, the legislature increased ongoing state support for K-12 for the 2009 biennium by $83.5 million, instituted full-time kindergarten, and instituted one-time only support of $45.0 million.

In February of 2008, the plaintiffs in Columbia Falls v State of Montana filed a motion in the district court alleging that the State's school funding formula still failed to provide adequate funding for fiscal year 2009. Plaintiffs also alleged that the current funding formula does not reflect the cost of a basic quality education and that the current formula contains elements that are essentially the same as those that were suspect in the original suit. The case was heard in Judge Sherlock’s district court the week of September 22-26, 2008. The State argued that the QSIC had determined the cost of a basic system of quality education, and that the current spending levels by the K-12 system were actually above those costs, and that the changes to the K-12 system legislated in the past four years – the four new components, three year averaging of ANB, full-time kindergarten, inflation of the basic and per-ANB entitlements and special education, and increased guaranteed tax base aid – represented nearly 17 percent of 2009 district general fund budgets. On December 9, 2008, the District Court declined to grant any supplementary relief to Plaintiffs.

While the most recent court action upheld the state position, it is not yet clear whether there will be an appeal, and the issue of adequate funding for schools is likely to be contested well into the future. The legislature needs to be aware of this issue as it considers the budget for K-12 education.

WILDFIRE FUNDING

Montana has incurred obligations for fire suppression costs of $53.0 million in FY 2008 and $6.0 million in FY 2009 for a total of $59.0 million for the biennium.

Historically, fire costs have been paid temporarily from the Forestry Division's general fund appropriation and through the Governor's statutory emergency appropriation if an emergency or disaster is declared. The department is then reimbursed and all other bills, except those paid with emergency appropriation authority, are funded through a supplemental appropriation. This "unfunded liability" approach to such a significant biennial cost, especially with the dramatic increase in wildlfire costs, has been significant, and in some cases, has resulted in special sessions to provide sufficient funding.

At the end of the FY 2008 fire season, the department was unable to utilize these "unfunded" tactics to pay the fire bill due primarily to the magnitude of the bill in relation to the department's budget. The Governor called a special session for the legislature to appropriate $39.0 million to the department and an additional $3.0 million to the Department of Military Affairs.

While in special session, the legislature established a fire suppression fund for FY 2009 only by transferring $40.0 million general fund to the fund and created a Fire Suppression Interim Committee, charged with the following:

- An investigation of firefighting operations in Montana, including operations on tribal land and private land, by the state and federal governments and the management policies affecting the success of those operations
- An investigation of the efficient use of fire suppression resources including equipment and firefighters
- An investigation of impacts of operations on private land and on the effective use of private resources to fight fires
- An investigation of state and federal forest management police and how those policies may contribute to an increased number of wildfires, greater safety risk to firefighters, or compromised effectiveness of fire suppression efforts

The interim committee was essentially tasked to deal with the changing realities of fire suppression such as increased costs, decreased FEMA assistance, fire locations, and changing relationships with federal partners.

FIRE SUPPRESSION FUNDING

The state cost of fire suppression is on the rise due to increased fuel costs, federal land management decisions, wildland urban interface development, and decreased federal assistance. The interim committee examined these issues to determine funding options for legislative consideration. Two options resulted in committee legislation. They are:

- Provide for an on going fund transfer to the fire suppression account; remove the termination date for the fire suppression account; and allow a certain amount in the account to be used for additional county co-op equipment, fuels mitigation, and rural fire assistance matching grants (LC 503)
- Increase the Governor's emergency fund and provide that the increase only be used for wildland fire (LC 504)

The committee also discussed relying on the supplemental appropriation process and developing a specific funding formula. Neither of those ideas resulted in committee legislation. For additional information on the Fire Suppression Interim Committee activities, see Legislative Budget Analysis, Volume 5, page C-244 for Agency Issues within the Department of Natural Resources and Conservation.

LONG-TERM STABILITY OF THE GENERAL FUND

INTRODUCTION

The state general fund is the primary account that funds a significant portion of the general operations of state government. Since this fund is critical to the operations of state government, the long-term stability of this account is an issue that must be examined for development of sound fiscal policies. This section discusses three key issues relevant to the 2009 legislative session and the necessary planning for subsequent sessions. The issues addressed are: 1) revenue stability; 2) reliance on federal funds; and 3) funding demands.

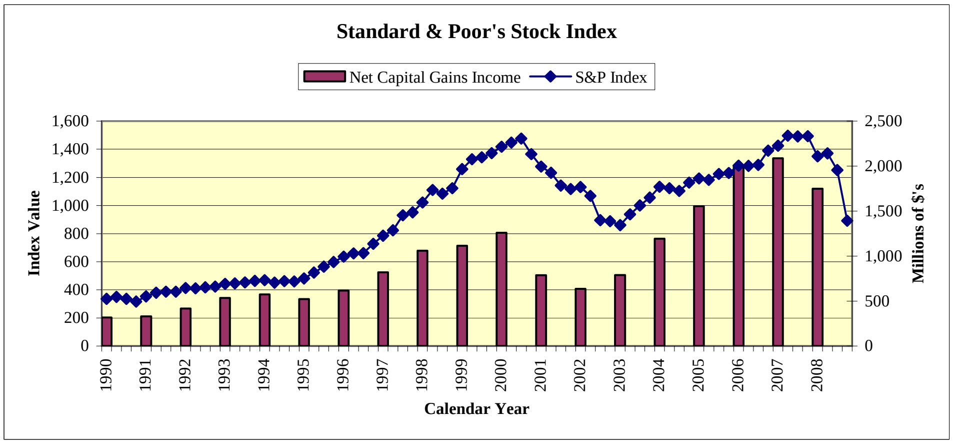
REVENUE STABILITY

There are three major components of general fund revenues that have contributed to increased revenue collections in recent years: capital gains income, oil and gas price and production, and corporate profitability. Reliance on capital gains upswings is the "poster child" of over-reliance on sustained growth, and expanding government services based on unsound fiscal policy.

CAPITAL GAINS

The 1990's were generally good years for Montana's economy. With a few exceptions, Montana experienced above average employment and wage levels that translated into strong tax revenue growth. This revenue growth was further enhanced by the significant increase in the equity markets and the resulting growth in capital gains income. During calendar 2002 and 2003, however, the state's financial picture blurred as the effects of a national economic recession, terrorism threats, and mid-east tensions played havoc on the US economy. Although Montana's economic base remained relatively stable during this period, state general fund revenues plummeted. This inconsistency was due to the precipitous fall in equity markets, low interest rates, and reduced corporate profits. All of these factors contributed to the 2002/2003 budget crisis while the state's economy continued to outperform the national economy.

Figure 5



As Montana moves forward into the next century, there are valuable lessons that can be extracted from the financial experiences of the 1990's. For example, as the information technology age was exploding during the nineties, the equity markets were experiencing phenomenal growth rates. As shown in Figure 5, the S&P stock index reached a high of almost 1,500 in calendar 2000 and then declined abruptly until 2003 when the index dropped to about 850. Figure 5 also shows the corresponding trend in net capital gains realizations as reported on Montana's tax returns. As the figure shows, the trends in reported net capital gains income is highly correlated to the S&P index. This would indicate that state tax revenues experienced significant growth from the mid to late nineties due to the information technology investment euphoria. In the meantime, while this growth scenario was occurring, state general fund expenditures were increased along with passage of significant tax relief measures. The actions of the legislature, in essence, expanded the expenditure base and reduced the tax base based on the assumption that strong revenue growth would continue indefinitely. Obviously, the budget crisis of 2002/2003 refuted this supposition. For the calendar period 2005 - 2008, an ominously similar pattern has developed, clearly shown in Figure 5. Reliance on continued levels of capital gains income could lead to another fiscal crisis. A careful assessment of the long-term stability of these levels of income is warranted.

Oil and Gas Production

Again for the calendar period 2005-2008 , a similar situation has developed in the oil and gas production component of state revenues. Montana's oil and natural gas revenues have increased significantly when compared to previous biennia. The issue is whether these increased revenues are "on-going" or are a short-term "blip" (similar to net capital gains income) that may fade in the future.

Figure 6

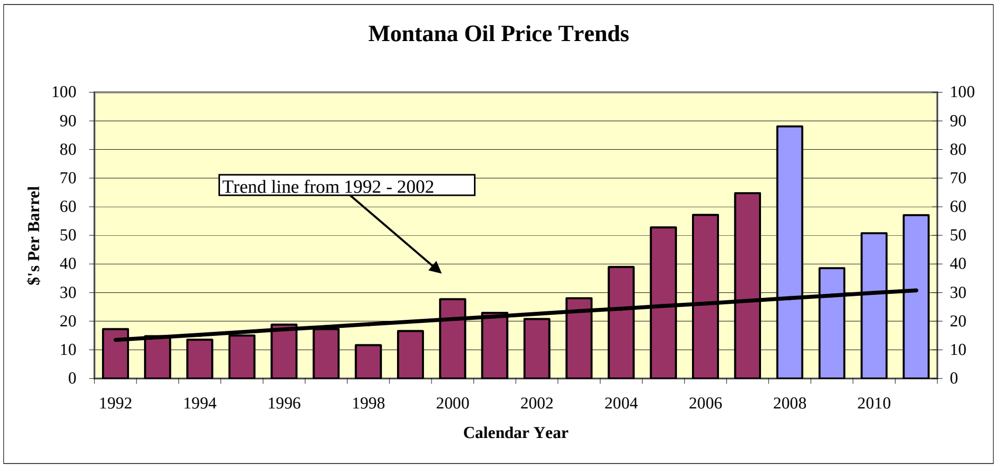
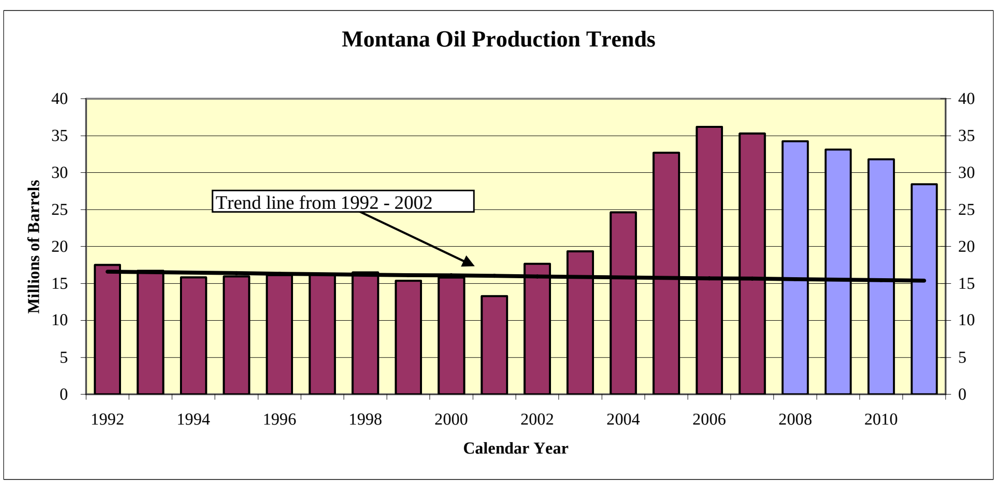
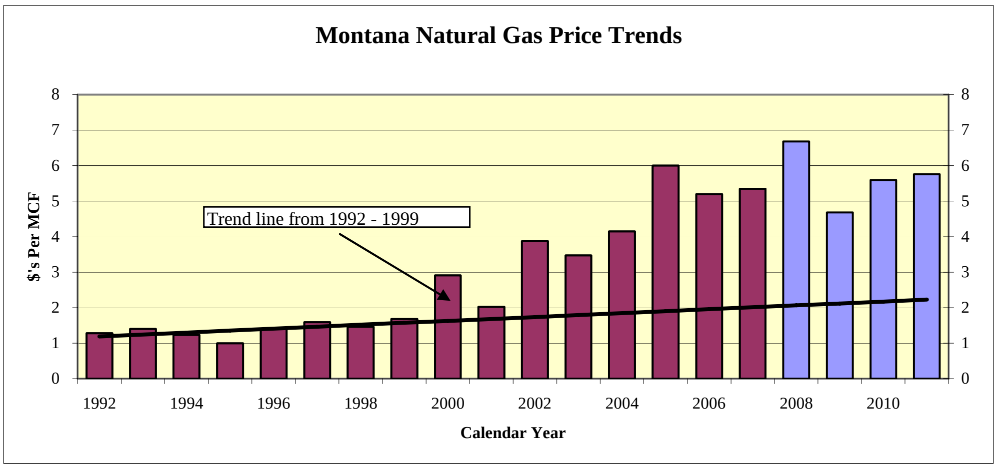


Figure 7



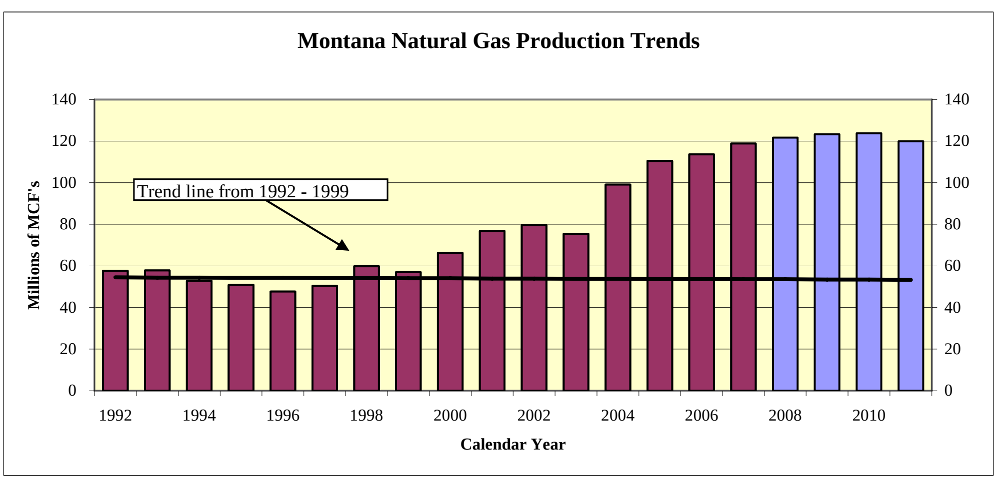
Figures 6, 7, 8 and 9 show the trends in Montana's price and production for oil and natural gas. The data shown for calendar 1992 through 2007 are actual information extracted from the Department of Revenue's computer system. The estimates shown for the calendar period 2008 through 2011 are based on assumptions prepared by the Legislative Fiscal Division (LFD). In addition to the actual and estimated amounts, the figures also show a trend line based on the calendar years indicated in the annotations. These trends are based on a common statistical technique that minimizes the differences between the trend estimate and the actual amount. The trend lines are extrapolated into the future to indicate what the "trend" would be under a status quo situation.

Figure 8



As shown in the figures, both oil and natural gas prices have increased dramatically through calendar 2008. The increase in oil prices is primarily in response to strong world demand and limited supplies.

Figure 9



Based on December 2008 forecasts by IHS Global Insight, the LFD has revised its recommended assumptions for both oil and natural gas prices. As shown in the figures, it is quite apparent that the price assumptions recommended by LFD are expected to peak in calendar 2008 and then drop off dramatically in calendar 2009. Prices are expected to rebound to some degree beginning in calendar 2010.

It is clear from the price and production data shown in the figures that oil and gas tax revenues for calendar 2005 -2008 have been considerably higher than the trend line would have produced. If the LFD recommended price assumptions are correct, state revenues will fall significantly during the next biennium as compared to the current biennium. The issue then becomes what will be the level of "on-going" revenue from oil and gas productions taxes. The legislature should be visionary in the budgeting process and adopt reasonable oil and gas price assumptions that will not create a boom or bust cycle into the future.

Corporate Income

Corporate income taxes have traditionally been an extremely volatile source of revenue, directly tied to the national and world economic conditions and its erratic fluctuation. While corporate taxes are currently strong, this tax source is expected to drop off significantly during the 2011 biennium. Again, it is prudent to assess the long-term trend of this source and how sustainable these revenues will be into the future. A significant portion of current corporate income taxes is being "fueled" by the natural resource industry. Lower commodity prices, however, are expected to reduce corporate profitability and the associated corporation tax payments. This is just one more example of a revenue source that can be quite volatile which makes the long-term stability of general fund revenues questionable.

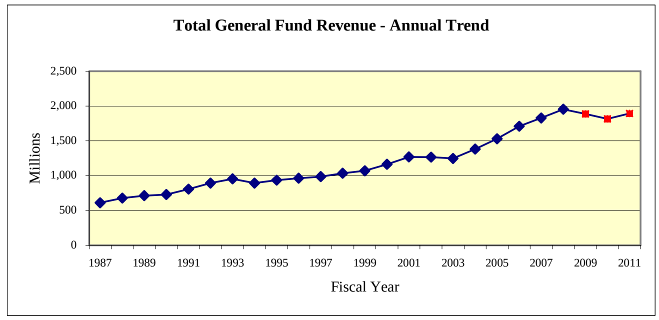
Revenue Stability-Summary

As shown in Figure 10, total general fund revenues have increased substantially during the period fiscal 2004 through 2008 and are projected to decrease during FY 2009 and 2010. Anticipated revenues are expected to begin a recovery starting in FY 2011

Figure 10

General Fund Revenue Trends
Historical Collections and LFD Estimates

	Fiscal Year	General Fund Collections Millions	Year to Year Change Millions	GF Percent Change
A	1987	609.742		
A	1988	676.718	66.976	10.98%
A	1989	711.968	35.250	5.21%
A	1990	730.351	18.383	2.58%
A	1991	805.288	74.937	10.26%
A	1992	892.727	87.439	10.86%
A	1993	953.063	60.336	6.76%
A	1994	891.859	(61.204)	-6.42%
A	1995	935.348	43.489	4.88%
A	1996	963.193	27.845	2.98%
A	1997	986.570	23.377	2.43%
A	1998	1,034.382	47.812	4.85%
A	1999	1,069.982	35.600	3.44%
A	2000	1,163.638	93.656	8.75%
A	2001	1,269.472	105.834	9.10%
A	2002	1,265.713	(3.759)	-0.30%
A	2003	1,246.381	(19.332)	-1.53%
A	2004	1,381.565	135.184	10.85%
A	2005	1,530.949	149.384	10.81%
A	2006	1,708.166	177.217	11.58%
A	2007	1,829.872	121.706	7.12%
A	2008	1,953.540	123.668	6.76%
F	2009	1,885.741	(67.799)	-3.47%
F	2010	1,816.452	(69.289)	-3.67%
F	2011	1,893.490	77.038	4.24%



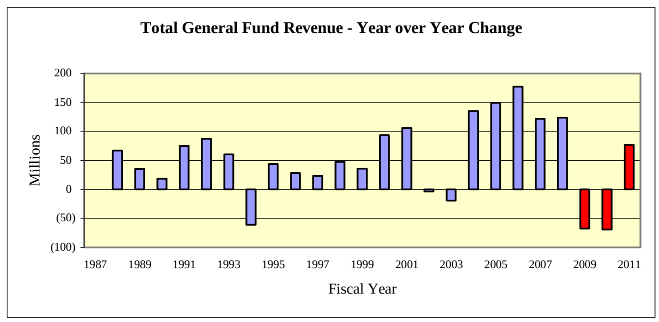


Figure 10 also shows the change in revenue collections from year to year. The disturbing trend is the downturn in revenue collections observed at seven to eight year intervals. As shown in the figure, this downturn is expected to occur in FY 2009 and 2010, earlier than the seven to eight year cycle observed historically

The downturn in revenues during FY 2002/2003 illustrates the sensitivity of Montana’s revenue stream to world events and investment opportunities. It also underscores the potential inaccuracies in the revenue estimates if the occurrences of these types of events are not known or are mistimed. Economic upturns or downturns are rarely accurately projected nor can disasters or certain world developments be anticipated. To quantify current collection patterns, the increased revenue collection from fiscal 2004 to 2008 was primarily due to three general fund revenue sources: individual income, corporation income, and oil and gas production taxes. Together, these three sources of revenue contributed about $707 million of the total increase, which represents over 80 percent of the total. The various assumptions used to estimate these revenue sources will have a substantial impact on total estimated general fund revenues in the future. If only a few of the key assumptions miss the mark, estimates may vary widely from actual collections.

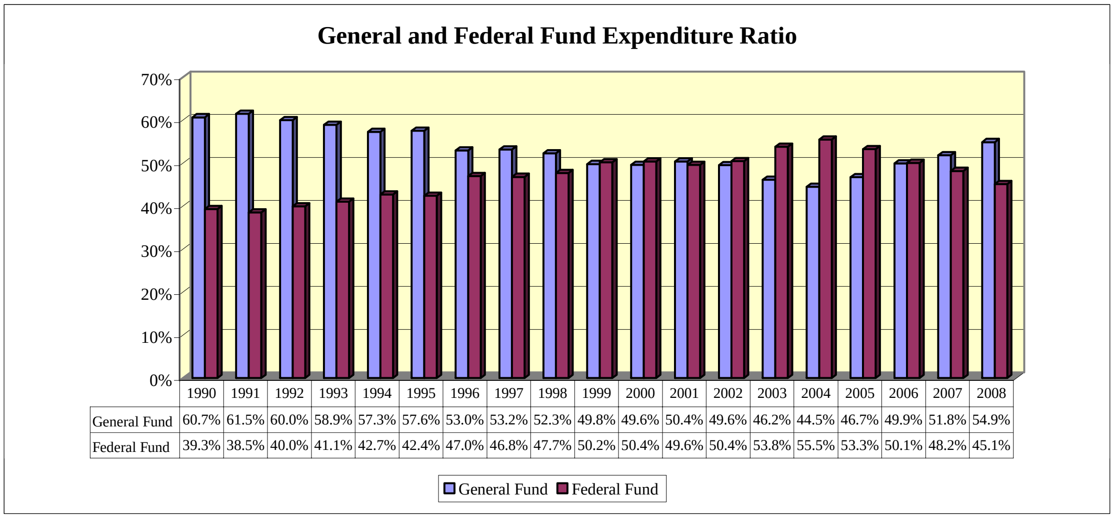
RELIANCE ON FEDERAL FUNDS

General fund expenditures have increased on average about 6.3 percent per year from fiscal 1990 to 2008. Correspondingly, federal funds expended have increased about 7.7 percent per year during this same period. In both funds, however, there have been some budgetary changes that skew these percentages. For example, HB124 (local government entitlement legislation), diverted some local government revenues to the state treasury in return for a state general fund entitlement appropriation to local governments. This change increased general fund revenues by approximately the same amount of increased general fund expenditures. During the 2003 biennium, the state food stamp program was included in the budgeting process. Prior to this time, this program was considered “off budget” and was not included as a federal fund expenditure.

Regardless of these changes, the fact remains that federal funds were a larger portion of the total state budget until FY 2006. Beginning in FY 2007, this trend was reversed wherein general fund was once again a larger portion of the total state budget.

As shown in Figure 11, general fund expenditures represented over 60 percent of the combined general and federal fund expenditures in FY 1990. By FY 1999, the percentage split was about equal. By FY 2004, however, federal funds represented over 55 percent of the combined spending to about 44 percent from the general fund. Interestingly, the federal funds percentage has dropped to about 45 percent in FY 2008. Total federal funds expended in FY 2008 were $1.700 billion compared to $2.069 billion general fund, for a difference of $369 million. This shift in percentages was due to the unusually high amounts of one-time only disbursements in FY 2008. If Montana was to lose a portion of these federal funds, the impact on the services provided to the citizens would be significantly reduced. To maintain the same level of services would require a substantial change in state tax policy.

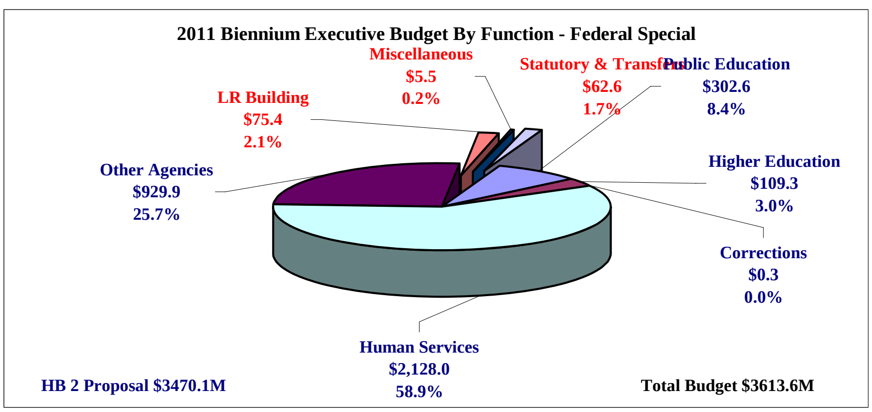
Figure 11



	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
General Fund	60.7%	61.5%	60.0%	58.9%	57.3%	57.6%	53.0%	53.2%	52.3%	49.8%	49.6%	50.4%	49.6%	46.2%	44.5%	46.7%	49.9%	51.8%	54.9%
Federal Fund	39.3%	38.5%	40.0%	41.1%	42.7%	42.4%	47.0%	46.8%	47.7%	50.2%	50.4%	49.6%	50.4%	53.8%	55.5%	53.3%	50.1%	48.2%	45.1%

Figure 12 shows the 2011 biennium executive budget recommendation for federal special revenue funds. As the figure shows, public health and transportation services consume over 58 percent of the federal funds recommended in the executive budget. A reduction in federal funding would have a significant impact to these state programs.

Figure 12



Reliance on Federal Funds - Summary

With huge federal deficits and the continued Iraq war funding demands, the prospect for federal funding freezes or reductions is a real possibility, not only in the near-term but also in the long-term. The current economic crisis has begun to impact federal revenues and will continue to have substantially impacts well into the future. The 61st

Legislature may want to consider developing a long-range plan in the event of a reduction in federal funds.

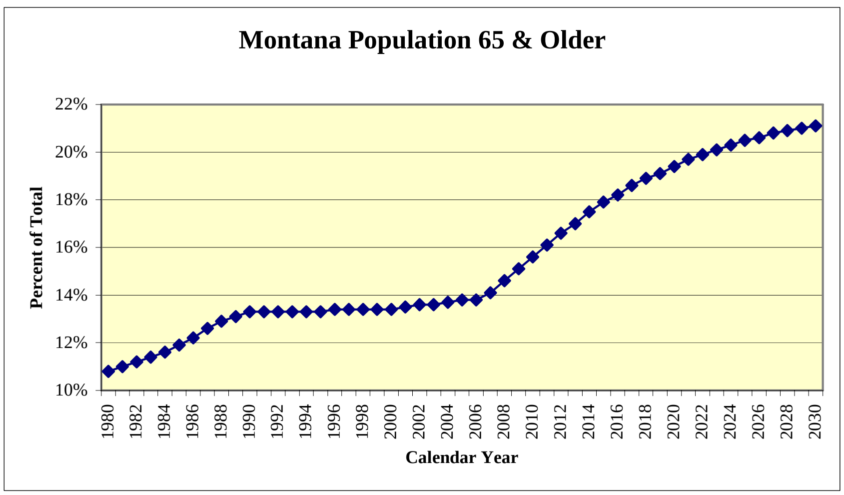
FUNDING DEMANDS

Businesses as well as government constantly experience the changing and competing demands for available dollars. Whether a business is contemplating expansion or technology enhancements, state government experiences the same type of needs and priorities in order to continue services to the citizenry of the state.

Aging Population

One of the most significant events that is beginning to surface in Montana is the projected increase in the aging population. Between 2002 and 2025, Montana's population 65 and older is expected to increase from 13.6 percent of the total population to 22.1 percent, or a change in older residents of almost 100,000. As shown in Figure 13, Montana experienced rapid growth in this age cohort from calendar 1980 to 1990.

Figure 13



Starting in calendar 1991 and through 2002, this trend waned, with the percentage of residents in this age bracket remaining quite constant. From calendar 2002 to 2025 this trend is once again changing, showing a significant percentage of Montana's total population in the 65 and older age range. If these projections are correct, by calendar 2025, one out of every five Montanan's will be at least 65 years old.

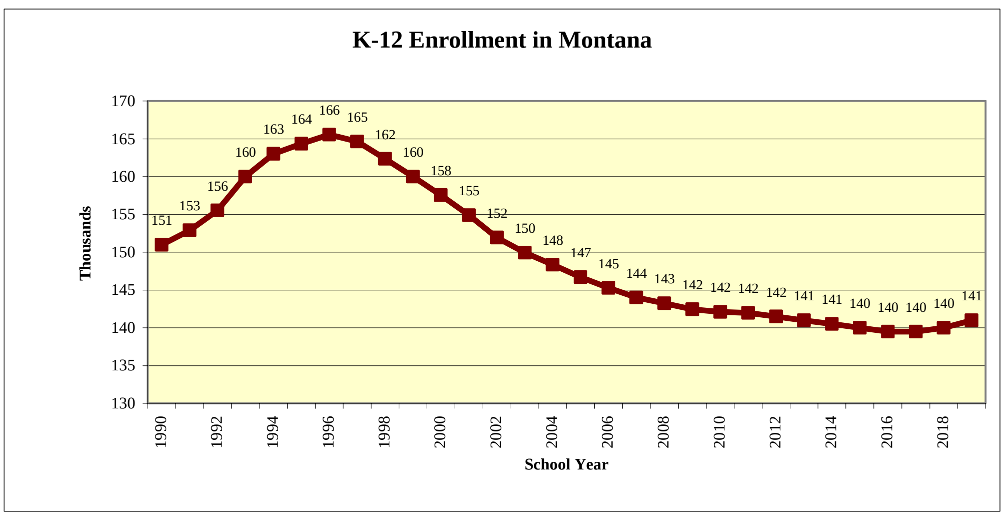
The primary cause of this rising population change is the maturing of the baby-boomer generation, born between 1946 and 1965. Montana, like other state and local governments, will need to address the issues relative to changing demographics. As Montana's population ages, issues relative to an economy that will be required to support these changes and the implications for medical and long-term care costs must be addressed.

With a growing elderly population, the legislature will need to address how the working-age population can support a significantly older population. In addition to the associated costs of caring for the elderly, the level of income these individuals have, and ultimately how much they will pay in taxes could have a substantial impact on state government finances. Given the expected dramatic changes in the age structure of our population, it is imperative the legislature begin thinking about these issues and how they may be addressed in the future.

During the 2007-08 interim, the RTIC and the LFC formed a subcommittee to discuss the fiscal implications of an aging population and other demographics on state revenues and expenditures. Their work resulted in a study proposal which is being brought to the legislature via HB 81. This legislation would create an interim committee to conduct a study of the potential long-term effects of demographic, economic, social, and other trends in Montana. State and local governmental programs and services, and state and local revenue systems would be studied.

School Enrollment

Figure 14



In addition to our aging population, Montana has experienced a significant change in enrollment in our elementary and secondary public schools. As shown in Figure 14, Montana's total enrollment was in excess of 165,000 children in school year 1996. From this time forward, total enrollment is expected to decline to about 140,000 students by school year 2015. Beyond 2015, enrollment is estimated to increase, but at a fairly moderate rate. The significance of this change is the costs associated with funding our current public school system. Under current law, state expenditures for public schools are primarily driven by the enrollment in each district. If enrollment declines, then the cost to fund education correspondingly declines. See page xxx for a discussion on the current public school funding lawsuit.

If the current public school funding formula continues to be enrollment driven, the cost of funding the public school system will begin to accelerate when the current enrollment trends reverse direction beginning in school year 2015. At an average cost of about $3,900 per enrollee per year, small changes in enrollment can turn into significant funding increases in the future.

Funding Demands - Summary

Changes in population demographics related to an aging population and a reversal of the decline in school enrollments are just two examples of funding demands. The chronic demands for increased human services and corrections funding are well known, and there are other troubling signs that funding demands could exacerbate the long-term stability of the general fund.

CONCLUSIONS

Ensuring that the general fund is structurally balanced, i.e., that on-going revenues meet or exceed on-going expenditures for the next biennium, provides a simplistic short-term assessment of sustainability of the general fund. However, it does not take into consideration the long-term stability of the funds or whether long-term trend assumptions are based on sound fiscal policies. This section discussed three key issues related to long-term stability that may point to tougher times ahead. With regard to revenue stability, individual income taxes, oil and gas production taxes, and corporate income taxes account for 80 percent of revenue growth in the past five completed fiscal years. Further reliance on sustaining these revenues at current levels into the future would ignore ominous signs that warrant careful scrutiny. With regard to federal funds, the executive budget proposes replacing $25.6 million federal funds with general fund due to the changes in FMAP rates. This appears to be the tip of the cutbacks anticipated as the Federal government deals with huge deficits. Regarding funding demands, shifting demographics related to aging population and school enrollment, as well as challenging chronic growth patterns with corrections and human services, signal yet another reason for concern with long range stability of the general fund. Collectively, these sample issues bring into question the sustainability of an executive budget proposal that, while “structurally balanced” from a simplistic short-term perspective, may lead to budget shortfalls in the not-too-distant future.

LFD ISSUE

While revenue estimates and spending proposals in the executive budget may be based on the best information available, particularly with regard to future sustainability, if only a few key assumptions miss the mark, it could lead to budget shortfalls in the long-term. The legislature should carefully consider the issues surrounding the sustainability of the proposed executive budget, and determine the level of risk that is acceptable in consideration of the vulnerability of any economic forecasting assumptions. For the longer-term, an in-depth analysis of the long-term stability of the general fund would require a fairly extensive analysis, but may be prudent given the serious impacts of over-extending based on erroneous assumptions.

The legislature should carefully consider the interim study bill (HB 81) that will study the long-term stability of the general fund. Much could be learned from examining the fiscal policies on which the current general fund structure is based.

Based on this outlook, it could be argued that a significant amount of additional revenue received during the last five years that is currently classified as “on-going” could be considered “one-time” and may not be available in subsequent biennia. If this hypothesis is correct, the 61st Legislature should consider creating a “rainy day fund” and transferring a portion of the potential one-time revenue into this fund. On November 18, 2008, the Legislative Finance Committee approved draft legislation that would create a “budget stabilization account”, a term synonymous with “rainy day fund”. Given the tenuous nature of some assumptions regarding the long-term sustainability of general fund, a rainy-day fund would provide a cushion to get through the down-side of economic cycles.

FUND BALANCE ADEQUACY/RESERVES

Attaining general fund budget stability means more than setting appropriations equal to anticipated revenues, with a positive ending fund balance serving as a safety net. The adequacy of the state general fund balance can signify the difference between whether or not the state is forced to confront the unpleasant consequences of fiscal instability. The legislature needs to be aware of the tenuous nature of the projections and keep in mind the need to maintain an adequate reserve.

BACKGROUND

Montanans are all too familiar with the consequences of general fund balance inadequacy. In the late 1980's and early 1990's, the state general fund experienced a chronic deficit between revenues and disbursements. Much of the growth in the disbursement rate is a result of natural growth in expenditures due to inflation and/or caseload and enrollment increases, as well as supplemental spending for such contingencies as fire suppression. Revenue growth in the state has not always kept pace with expenditure growth. During the 2003 biennium, actual revenue growth was well below forecasts, primarily because of reduced income tax collection and lower interest rates, largely due to circumstances that could not be predicted when the 2003 biennium budget was being approved. The legislature adjourned from the 2001 regular session with a projected 2003 biennium general fund ending balance of $54 million (2.3 percent of biennial appropriations). By the end of the first fiscal year, revenue collections for the biennium were $153 million below legislative estimates. Even after the Governor directed statutory spending reductions of $23 million, a special session was necessary to achieve an acceptable ending fund balance reserve through an additional $59 million in budget balancing actions. Revenues still remained unstable as the Fifty-eighth Legislature imposed additional reductions as it shaped the 2005 biennium budget, ending the session with a projected fund balance of $46.2 million or 1.7 percent. As the economy bounced back in the 2005 and 2007 biennia, Montana witnessed extraordinary revenue growth, with a record fund balance approaching $1 billion projected through the 2009 biennium. The Governor's proposed budget for the 2009 biennium coupled with the 2007 Legislature's actions through appropriation and tax relief measures, resulted in a projected 2009 biennium ending fund balance of $184 million. A 2007 special session to address wildfire costs reduced that amount to $125 million.

ADDRESSING FUND BALANCE ADEQUACY

Recognizing that budgetary imbalances and revenue swings can occur, the state can either take a reactive or a proactive approach. During the 1993, 1995, 2003 and 2009 biennia, the state held special legislative sessions to deal with budget shortfalls. Although special sessions allow lawmakers the ability to address issues relative to revenues and expenditures, special sessions can cost the taxpayers more than $50,000 per day. The need for special sessions is also closely scrutinized by the national agencies that rate the state's debt. Rating agencies also use a state's general fund balance as a percent of revenues as a key financial indicator for credit analysis.

Again from a reactive stance, budgetary fluctuation can be temporarily resolved through spending reductions. In accordance with 17-7-140, MCA, the Governor can authorize spending reductions: "...in an amount that ensures that the projected ending general fund balance for the biennium will be at least 1 percent of all general fund appropriations during the biennium." Essentially, the executive branch assumes control of the budget decision-making process by implementing and prioritizing spending reductions. Further, budgetary imbalances can be addressed only from one side of the equation -- expenditures. This means that legislative priorities could potentially get lost in the process.

Because of the cost and disadvantages of taking a reactive approach to budget imbalances, a more effective method may be to approach these issues proactively through provision of adequate fund balance reserves. National fiscal experts such as the National Conference of State Legislatures (NCSL) recommend a reserve fund balance of 3 to 5 percent of total appropriations or revenues. Because Montana's budget is implemented on a biennial basis -- resulting in considerably more risk than an annual budgeting process -- the 3 to 5 percent should be applied to biennial totals. For Montana, with projected total general fund revenues of $3.7 billion, a minimum 3 percent reserve equates to a $111.0 million ending fund balance. The revenue volatility of recent years might suggest that an even higher reserve would be more prudent.

The provision of an adequate general fund balance is essential to achieving a sound financial foundation. The level of fund balance reserves must be sufficient to offset the volatility of revenues and the potential for unforeseen expenditure increases, both of which are prevalent in recent years and in current budget proposals. It is even more important since Montana is one of only three states that do not have a rainy day fund provision (although the legislature is expected to consider one or more "rainy day fund" bills this session). To this end, the legislature will again need to determine what amount of ending fund balance is sufficient to ensure budget stability.

Executive Recommendation

The executive budget balance sheet as revised on December 15 shows an ending fund balance of approximately $295.5 million. The original executive budget recommends a fund balance of no less than $250 million, or about 6.7 percent of the executive's biennium revenue forecast, plus the executive budget includes nearly $33 million for the wildfire suppression account (the executive proposes removing the sunset provision on that account).

LFD COMMENT

The legislature may want to consider establishing a rainy day fund for what might be considered the excess fund balance reserve. The projected fund balance does not represent ongoing revenue and spending it down, if estimated revenues fall off further, would result in a deepening structural imbalance in the budget. In that event, the legislature may want input in how those funds are spent.

HIGHWAY STATE SPECIAL REVENUE DECLINE IN WORKING CAPITAL BALANCE

The state special revenue account that supports most state funding for operations and maintenance of Montana's highway infrastructure is in a perilous financial situation with key revenues declining and costs rising. Key revenue sources that fund more than 70 percent of state costs are from motor fuel taxes. Declining economic conditions, changing driving behaviors, and fuel economy efforts are causing motor fuel revenues to decline while inflationary pressures are causing highway infrastructure costs to rise. By the end of the 2011 biennium declining revenues and rising costs could result in an estimated deficit of $17.0 million for this key state funding source, the highways state special revenue account, to support operations and maintenance of Montana's highways under current expenditure projections.

A further discussion of this account and all related issues is included in Volume 5 of the LFD 2011 Biennium Budget Analysis, page C-126.

PENSION PLANS UNFUNDED LIABILITY

Does the legislature need to take action in the 2009 session?

One of the key fiscal issues in front of the legislature over the past few biennia has been the unfunded actuarial liability (UAL) of the state pension plans. In two different sessions (the December 2005 special session and the 2007 special session) the legislature approved cash contributions totaling $175 million to reduce unfunded liabilities and shore up plan assets that had been impacted by reduced equity market values and a downturn in investment earning generally. In FY 2007, the equity markets regained value and at the end of June 2007, all of the pension plans were actuarially sound as defined in state statute. At the end of FY 2008, and after the equity markets dropped in value in the last month of the year, all but one of the plans still met the criteria of being actuarially sound. Only the Teachers' Retirement System was determined to be actuarial unsound.

BACKGROUND

Article VIII of the State Constitution states that "public retirement systems shall be funded on an actuarially sound basis. State law defines actuarial soundness by stating that the "unfunded liability contribution rate…must be calculated as the level percentage of current and future defined benefit plan members' salaries that will amortize the unfunded actuarial liabilities of the retirement plan over a reasonable period of time, not to exceed 30 years, as determined by the board." In other words, the contribution rate for a particular plan must exceed the level needed to cover the normal costs of benefits and administration for the retirees and be sufficient, when amortized, to cover the unfunded liability within 30 years.

MOST RECENT ACTUARIAL VALUATIONS

An actuarial valuation, by statute, is required annually for each plan. The valuations are prepared after the end of the fiscal year and are available to the respective retirement boards around the end of September of each year. Figure 1 summarizes key points of actuarial valuations for the year ending 6/30/2008, and provides a comparison to the previous two valuations (2006 and 2007). The four plans that are highlighted are those pension plans that were the focus of attention over the past few session as they were considered "actuarially unsound."

The key item to focus on in the FY 2008 data is the "Years to Amortize Unfunded Liability" which is highlighted. This is an important indicator because the definition of "actuarial soundness" is tied to the pension plan ability to pay down its unfunded liability within a 30 year period. As the figure shows, the Teachers' Retirement System is the only plan that exceeds the 30 year amortization, partly due to the reduced investment earnings and partly due to a change in actuarial assumptions approved by its board.

Figure 1

Pension Plan Unfunded Actuarial Liability
2008 Actuarial Valuation versus 2006 & 2007 Actuarial Valuations
(Dollars in Millions)

	TRS	PERS-DB	SRS	GWPORS	HPORS	MPORS	FURS	JRS	VFCA
2006 Valuation (as of 6/30/2006)									
Actuarial Liability	$3,608.9	$3,919.3	$171.8	$64.2	$112.0	$291.1	$255.5	$37.2	$31.9
Assets	2,745.8	3,459.1	163.0	58.8	87.2	175.9	167.3	51.8	23.2
Unfunded Liability (Surplus)	$863.1	$460.2	$8.8	$5.4	$24.8	$115.2	$88.2	($14.6)	$8.7
Funded Ratio	76.1%	88.3%	94.9%	91.6%	77.9%	60.4%	65.5%	139.2%	72.7%
Years to Amortize Unfunded Liability	Does not amortize	Does not amortize	Does not amortize	32.4 yrs	18 yrs	21.4 yrs	15.5 yrs	n/a	9.6 yrs
2007 Valuation (as of 6/30/2007)									
Actuarial Liability	$3,775.1	$4,201.2	$189.0	$73.0	$128.3	$310.4	$269.4	$36.9	$31.6
Assets	3,006.2	3,825.2	183.9	68.8	95.8	198.3	188.5	57.8	25.9
Unfunded Liability (Surplus)	$768.9	$376.0	$5.1	$4.2	$32.5	$112.1	$80.9	($20.9)	$5.7
Funded Ratio	79.6%	91.1%	97.3%	94.2%	74.7%	63.9%	70.0%	156.6%	82.0%
Years to Amortize Unfunded Liability [b]	28.6 yrs	21.9 yrs	19.6 yrs	11.3 yrs	19.1 yrs	20.5 yrs	12.9 yrs	n/a	5.1 yrs
Total Contribution Rate	16.730%	13.895%	19.070%	19.560%	45.380%	52.780%	57.660%	32.810%	[a]
Normal Cost Rate	10.400%	12.220%	19.460%	18.670%	22.310%	26.450%	26.050%	25.190%	
Available for Amortization	6.330%	1.675%	-0.390%	0.890%	23.070%	26.330%	31.610%	7.620%	
Avail. For Amort. FY 2010 [b]	6.710%	1.810%	-0.100%						
2008 Valuation (as of 6/30/2008)									
Actuarial Liability	$3,953.7	$4,504.7	$204.5	$83.4	$134.7	$327.5	$287.2	$39.4	$32.7
Assets	3,159.1	4,065.3	199.4	77.5	101.5	212.3	206.1	62.0	27.5
Unfunded Liability (Surplus)	$794.6	$439.4	$5.1	$5.9	$33.2	$115.2	$81.1	($22.6)	$5.2
Funded Ratio	79.9%	90.2%	97.5%	92.9%	75.4%	64.8%	71.8%	157.4%	84.1%
Years to Amortize Unfunded Liability [b]	31.3 yrs	24.8 yrs	16.3 yrs	13.0 yrs	17.4 yrs	18.6 yrs	11.3 yrs	n/a	5.0 yrs
Net Statutory Funding Rate	16.730%	13.895%	19.070%	19.560%	45.380%	52.780%	57.660%	32.810%	[a]
Normal Cost Rate	10.870%	12.130%	19.240%	18.540%	22.250%	26.650%	26.150%	25.120%	
Available for Amortization	5.860%	1.765%	-0.170%	1.020%	23.130%	26.130%	31.510%	7.690%	
Avail. For Amort. FY 2010 [b]	6.240%	1.900%	0.120%						

Notes [a] Contibutions are not expressed as a percent of wages but rather are a portion of the fire insurance premiums collected by the state.
[b] Contributions by employer increase 0.38% for TRS, 0.135% for PERS and 0.29% for SRS on July 1, 2009, resulting in an increased amount available for amortization. The number of years shown to amortize the unfunded liability takes these increases in employer contribution into account.

Key
TRS - Teachers' Retirement System
PERS - Public Employees' Retirement System
SRS - Sheriffs' Retirement System
GWPORS - Game Wardens and Peace Officers' Retirement System
HPORS - Highway Patrol Officers' Retirement System
MPORS - Municipal Police Officers' Retirement System
FURS - Firefighters' Unified Reirement System
JRS - Judges' Retirement System
VFCA - Volunteer Firefighters' Compensation Act

There are two points that need to be noted. First is that although this data does not look as bad as one might expect given the recent economic events, the valuation process applies a technique called "smoothing" that spreads gains and losses out over a period of time. Therefore, losses that occurred in FY 2008 are not totally realized in this current valuation, but rather are spread out over a four year period. Second, the current valuation does not take into account the impact of economic events since June 30, 2008, where retirement investments have seen some extraordinary volatility.

The next scheduled valuations will occur after June 30, 2009 and will not be available until around October 1. How the equity markets and other investments perform before the end of FY 2009 is unknown, but it is how they perform that will determine the soundness or unsoundness of the retirement plans in the next valuation, assuming that the actuarial assumptions remain relatively unchanged.

TOTAL UNFUNDED LIABILITY

The net unfunded liability of the nine defined benefits pension plans as of June 30, 2008 is $1.457 billion. A rough calculation of the change since June 30 suggests that the unfunded actuarial liability may have doubled since that time. The collective funded ratio, which was about 85 percent, could be in the neighborhood of 68 percent. The changes are dramatic but do not consider the actuarial assumptions of "smoothing" which refers the practice of spreading of gains and losses over a four year period. Still, there was an unsettling drop in asset value in just a couple of months time.

IS LEGISLATIVE ACTION NEEDED?

By definition and based upon the most recent actuarial valuation, all but one of the pension plans is actuarial sound. In addition, the actuarial soundness of these plans are based upon assumptions that measure the long-term trends of various factors, with investment returns certainly being a key one. When the legislature convenes in January, there will still be six months remaining in FY 2009 and the session will end prior to the availability of the 2009 valuation. The Teachers' Retirement System (TRS) is preparing a projection of what the funded status of TRS might look like using a range of different asset returns, with a report expected in mid- to late January. The Public Employees Retirement System (PERS) is considering similar scenarios. This information might give the legislature some idea of whether or not there is a compelling reason for the legislature to take any action in the 2009 session.

Historic economic cycles and the logic of actuarial valuations would suggest that time will resolve the pension plan unfunded liabilities to the degree needed for actuarial soundness. Even the retirement boards have a policy that provides that after two consecutive "negative" valuation reports, the boards are obligated to pursue legislative remedies (TRS has had one with the most recent report and PERS has had none so far). The question then becomes: How long might a recovery take? The answer to that question will not likely be evident in the near future.

Further, the contributions to the pension plans are sufficient to cover the normal costs of the plans, that being the actuarial cost to fund the benefits provided by the system and administration were the funding to begin at date of hire. What will not be known until the next actuarial valuation is the degree to which investment losses have increased the unfunded actuarial liabilities, and the cost to amortize those unfunded actuarial liabilities within the 30-year threshold.