LEGISLATIVE BUDGET ANALYSIS
2005 Biennium
Volume 1 – Statewide Perspectives

Presented to the Fifty-eighth Legislature

Submitted by

The Legislative Fiscal Division

Helena, Montana

January, 2003

MONTANA LEGISLATIVE BRANCH

Legislative Fiscal Division

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Legislative Fiscal Analyst
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December 2002

Members of the Fifty-eighth Legislature:

I submit for your consideration a fiscal analysis of the state budget outlook for the 2005 biennium and Governor Martz's Executive Budget. It is our goal that this analysis will provide the information and insight necessary for legislators to craft an effective state budget and fiscal policy for the 2005 biennium. This four-volume report includes:

- Volume 1: Statewide Perspectives – This volume provides a summary overview of the state fiscal outlook and the executive budget analysis as well as a general reference section.

- Volume 2: Revenue Estimates – This volume provides the revenue estimates and underlying economic assumptions included in the revenue estimate resolution (HJR 2), and is designed as a working document for the taxation committees.

- Volumes 3 and 4 – These volumes are designed to serve as working documents for the appropriations subcommittees. They provide:
  - The Governor's agency budget recommendations, and
  - The Legislative Fiscal Division's detailed descriptions and analysis of the various components of the Executive Budget.

Your staff of the Legislative Fiscal Division look forward to being of service to the legislature during the 2003 session. We welcome any opportunity to assist you in obtaining the best possible fiscal information to facilitate setting fiscal policy. Staff names, assignments, and phone extensions are listed on page xiii. Please feel free to call on us!

Respectfully submitted,

Clayton Schenck
Legislative Fiscal Analyst

This analysis was created
In accordance with Section 5-12-302, MCA
by the Legislative Fiscal Division.

I am deeply indebted to an exceptional LFD staff
for their thousands of extra hours
and personal sacrifice in preparing this analysis.
Their dedication and professionalism
are a credit to the Legislature and the citizens of Montana.

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and agency directors and budget personnel
for their gracious cooperation
in this budget analysis effort.

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in publishing this report.

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How to Use This Report

The *Legislative Budget Analysis, 2005 Biennium* is published in four volumes. The report is designed to assist the 2003 legislature in setting fiscal priorities and to help legislators reflect those priorities in the 2005 biennium General Appropriations Act (HB 2).

Volume 1

Volume 1, which includes a legislative summary, provides an overview of the proposed budget. *Volume 1* also summarizes significant fiscal issues that may impact more than one agency or that do not fall under the jurisdiction of a single appropriation subcommittee. Generally, this volume attempts to answer the following questions:

1. What is the state's fiscal condition?
2. What are the major fiscal challenges facing the 2001 legislature?
3. What is the executive proposing for the 2003 biennium?
4. What are the significant issues identified by the LFD analysis?
5. What other fiscal issues are important to consider?

The "State Budget Outlook" section on pages 1 through 26 provides a high level summary of the material presented in *Legislative Budget Analysis*.

This volume is structured to present a general fund outlook for the 2003 biennium and 2005 biennium, an analysis of the *Governor's Executive Budget* proposals including issues identified by the LFD analysis, and a discussion of other fiscal issues that are related to the budget deliberations. The reference section, at the end of *Volume 1*, presents a range of budget-related material. This section is considered especially useful for new legislators and those who have not previously had direct involvement in the appropriations process.

An index in the back of *Volume 1* is the most comprehensive for the purpose of searching for information in all four volumes.

Volume 2

Volume 2 includes a summary and overview of the state's major revenue sources. A review of the table of contents will give the reader a quick idea of revenue sources included and the structure of the report. This volume will be provided to the House and Senate Taxation committees for use as a working document, and delineates the economic assumptions used to derive revenue estimates adopted by the Revenue and Taxation Interim Committee (RTIC) and introduced in the revenue estimate bill (HJR 2).

Volumes 3 and 4

Volumes 3 and *4* offer detailed analyses of individual agency budgets, as proposed through the Governor's Executive Budget submitted in mid-November. These volumes feature program-by-program detail, as well as the LFD analysis of each agency budget. Agency presentations are grouped in sections corresponding to the appropriations subcommittee addressing the agency.

Volume 3:

A – General Government and Transportation
B – Health and Human Services

Volume 4:

C – Natural Resources and Commerce
D – Corrections and Public Safety
E – Education
F – Long-range Planning

A specific agency can be located in any of three ways. The general index included in each volume provides an alphabetical listing of agencies and other topics, in conjunction with appropriate volume and page numbers. If the subcommittee addressing a given agency is known, the cover page of each section lists agencies, in order by appearance. Agency names are also visible on page headings within their respective sections.

Volumes *3* and *4* briefly describe the agencies from all three branches of state government, as well as each program within an agency. The basic structure used for the analysis is consistent across agencies. These volumes detail an agency's requests, as well as a list of proposals and issues significant to the agency. When appropriate, there may be discussion of circumstances that could hold budgetary impacts (e.g., proposed executive legislation or agency reorganization). These volumes also present detailed discussions of present law adjustments, new proposals, and significant issues facing the various agencies as identified by legislative fiscal analysts.

Agency budgets are presented in three tiers as required by statute:

1. **Base budget:** the level of funding authorized by the previous legislation;
2. **Present law base:** the additional level of funding needed under present law to maintain operations and services at the level authorized by the previous legislature; and
3. **New proposals:** requests to provide new non-mandated services, to change program services, to eliminate existing services, or to change sources of funding.

By making this presentation in this tiered manner, legislators can use the "base budget" as the starting point, then to follow the incremental increases that result in a total budget request for an agency.

Proprietary Rate Setting

HB 576 (1995) removed the requirement that proprietary – or internal service and enterprise – funds be appropriated by the legislature. Instead, the legislature approves the rates charged for those particular services and products. HB 576 also requires the Office of Budget and Program Planning to submit a report as part of the Executive Budget. This report includes fees and charges, projected fund balances, retained earnings, and contributed capital for providers. Although the legislature does not appropriate funds for the operation of these programs, it does approve the rates charged. These reports and the LFD analysis of the reports are included in the agency presentations in volumes *3* and *4*, as appropriate.

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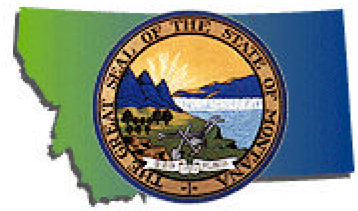
What is the state budget outlook?



INTRODUCTION

For the first time in over a decade, Montana is experiencing a substantial general fund budget shortfall, estimated at $230 - $250 million for the biennium relative to present law budget requirements. The cause of the deficit is primarily due to: 1) a sharp decline in individual income taxes on and capital gains; 2) a decline in corporation income tax; and 3) an increase in state expenditures driven by human service caseloads and medical costs. In this challenging fiscal environment, the 58th Legislature faces the daunting task of developing a budget that preserves funding for the state's highest priority services, but also addresses the large deficit.

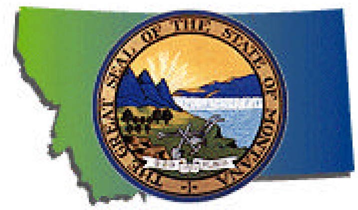
In this first chapter, we provide an executive summary of the state budget outlook. It includes a state economic overview, how those economic conditions affect the state fiscal outlook and the general fund budget in particular, the projected deficit, and the proposed executive budget solution/highlights. We then summarize the major fiscal challenges this legislature faces, the executive response/solutions to the challenges, and issues regarding those challenges/solutions. Other significant fiscal issues facing this session are also highlighted, as well as a brief summary of other states' budget woes and solutions to the nationwide state budget crisis.

In a nutshell, this section provides summary answers to the following questions:

- What is the current economic profile of Montana?
- What is the state's fiscal condition?
- What is the projected budget deficit?
- How does the executive propose to solve the deficit?
- What are the key features of the executive budget?
- What are the major fiscal challenges facing the 2003 legislature?
- What are the executive solutions?
- What are the significant issues identified by the LFD analysis?
- What other fiscal issues are important to consider?
- Where did we go wrong? Is the budget crisis unique to Montana?

The majority of the issues discussed in this overview are discussed in more detail in the remaining chapters.

What is the current economic profile of Montana?



MONTANA ECONOMIC OUTLOOK

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

Montana's total revenue base is comprised of a number of taxes and fees plus numerous federal reimbursements or grants. Revenues are further enhanced from the investment of trust monies and idle cash pending disbursement from the state treasury. Since individual income tax is the state's largest general fund tax source, economic developments or trends in the areas of employment and income levels significantly influence available revenues to fund governmental services. Federal revenue correspondingly is used to fund a number of human service, transportation, and educational services. In a number of instances, general or state special revenue fund dollars are required to provide a state match before the federal funds can be disbursed.

Conversely, Montana's total expenditure base is targeted toward educational and human service programs with a significant allocation to highway construction. Education and human service costs are driven by some of the same economic and demographic conditions that influence state revenues. If employment levels increase, this usually translates to an increase in population or a reduction in unemployment levels. With population increases comes a corresponding increase in educational and human service costs. A greater population requires a better transportation system not only for the general populace but also for the businesses that expect to expand to meet the needs of an ever-growing population.

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. The future, however, does not look as good as the effects of a national economic recession, terrorism threats, and mid-east tensions play havoc on the US economy. All of these factors continue to weigh on the minds of investors, which is reflected by the bearish mood on Wall Street.

During calendar 2001, the Federal Reserve Board (FED) reduced interest rates 12 times in an attempt to stimulate the US economy. On November 6, 2002 the FED reduced interest rates further with an additional half point reduction. Many economists are now suggesting that the interest rate reductions may have little affect on the economy, since many businesses are reluctant to invest in business expansion and possess minimal control to increase prices. Many of the earnings reports issued by major US companies show slow growth and reduced revenues as the result of a sluggish economy. These trends translate to a similar slow-down in Montana's economy. Montana's economy is highly dependent on agriculture, tourism, natural resource extraction, and mining. All of these industries produce residual wholesale/retail trade and service sector jobs. If the basic industries are not flourishing, other sectors suffer as well. And if Montana's economy slows, tax revenue growth usually follows the trend because of the state's dependence on income tax revenues.

The irony of an economic slowdown is the inverse effect it may have on state expenditures. For example, if unemployment increases, this may translate into a greater demand for human service benefits and a greater need for correctional facilities and services. During a period when revenue growth is slowing, governmental service demands may actually increase at a faster rate.

The economic outlook for the state is very fragile at this time. Employment and wage indicators continue to support slow growth in the near-term with the prospect of a gradual recovery by 2005. Capital gains income is expected to further erode during calendar 2002 and 2003 with a return to pre-technology exuberance trends for calendar 2004 and 2005. While interest rates are at historic lows, corporate profits are expected to remain soft. Property values are expected to increase due to reappraisal. The 58th Legislature, however, may need to address this issue depending on the magnitude of the increases. The effects of lower interest rates may have some beneficial impacts on economic growth at the expense of reduced state revenues from investments.

What is the state's fiscal condition?
What is the state's projected budget deficit?

STATE FISCAL PICTURE

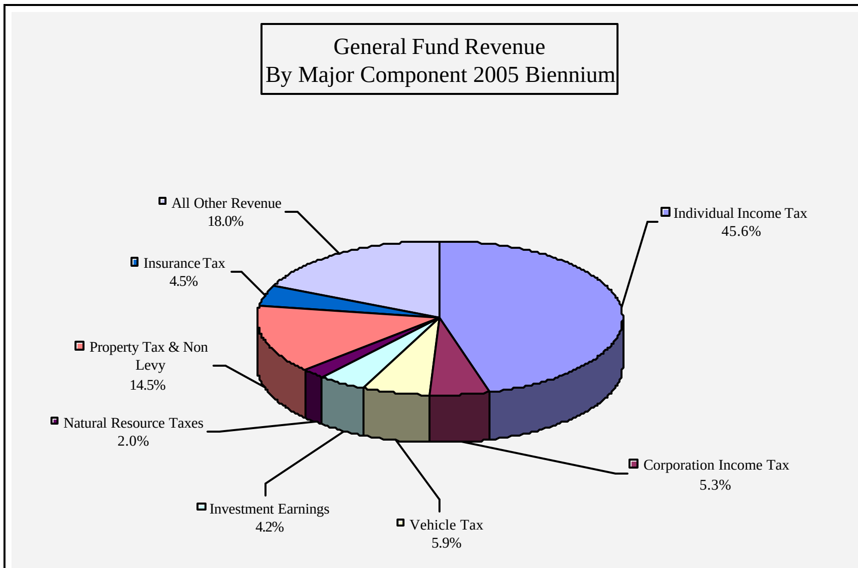
STATE FISCAL OUTLOOK

The previous section described the economic outlook for Montana from the perspective of how economic activity at both the state and national level impacts state revenues and expenditures. This section describes in more detail how those economic conditions determine the state fiscal outlook and ultimately the size of the 2005 biennium budget.

GENERAL FUND REVENUE IMPLICATIONS

Montana's fiscal outlook for revenue growth is much less optimistic than in previous biennia. The preliminary revenue estimates adopted by the Revenue and Transportation Interim Committee (HJR2) are based on a slowing economy through calendar 2003 with a gradual recovery by calendar 2005 at both the national and state levels.

As shown in the pie chart at the right, individual income tax, corporation income tax, property tax, vehicle tax, and investment earnings are expected to contribute over 75 percent to the total general fund revenue stream during the 2005 biennium. Total general fund revenues for the 2005 biennium are projected to increase 2.1 percent over the 2003 biennium projections. The comparative change by major revenue category is shown at the bottom of the figure.



Major Category	2003 Biennium Estimate Millions	2005 Biennium Estimate Millions	Percent Change
Individual Income Tax	$1,044.968	$1,151.213	10.17%
Corporation Income Tax	121.987	134.005	9.85%
Vehicle Tax	146.637	150.121	2.38%
Investment Earnings	146.593	105.489	-28.04%
Natural Resource Taxes	55.807	51.030	-8.56%
Property Tax & Non Levy	342.616	366.599	7.00%
Insurance Tax	98.737	114.479	15.94%
All Other Revenue	516.775	453.773	-12.19%
Total General Fund	**$2,474.121**	**$2,526.709**	**2.13%**

House Bill 7, enacted during the August special legislative session, created a new state special guarantee account, which receives deposits of interest and income, timber, and mineral royalty revenues from school lands. These monies were previously deposited in the general fund. This means that revenues for the 2003 biennium include school land revenue for fiscal 2002, but these funds have been removed for fiscal 2003. If the fiscal 2002 amount is adjusted to exclude this revenue, the adjusted general fund growth rate is projected to be 4.2 percent from the 2003 to 2005 biennium.

The key economic assumptions targeted as most affecting state government receipts are Montana total income (all sources reported as individual income tax income), employment and population levels, inflation rates, corporate profits, property values, interest rates, and energy prices. The impacts of the current economic situation are reflected in the assumptions that were used to derive the revenue estimates and key factors are briefly highlighted below. A more complete summary can be found on page 27 of this volume, and a detailed explanation for each revenue component is in Volume 2, "Revenue Estimates".

- Wage and salary income provides the largest portion of Montana total income. Average growth has been 5.5 percent over the past decade. For calendar 2002 and 2003, growth is slow, gradually increasing to about 5 percent by calendar 2005.
- Capital gains income increased sharply in relative importance during the 1990s, growing from 4.2 percent to 9.2 percent of total income. In 2001, capital gains income dropped by nearly 38 percent over 2000, and is projected to decline an additional 28 percent in calendar 2002. They are expected to remain flat in 2003, then "rebound" to a historic growth rate of 7.5 percent per year in 2004 and 2005.
- Average annual growth in employment has been 2.0 percent since 1996. In the forecast period, growth is gradual, from 0.8 percent in calendar 2002 to 1.8 percent in calendar 2005.
- Population growth was 2.3 percent in 1998, and is estimated at 0.9 percent annually in the next biennium. This factor impacts many of the consumption taxes.
- Since 1990, inflation has averaged 3.0 percent annually and is estimated at 2.9 percent during the next biennium.
- Between 1990 and 1997, U.S. corporation tax profits increased an average 3.9 percent per year, but have decreased an average 3.9 percent annually from 1998 through 2001. The decrease is expected to continue in 2002, and then begin a gradual recovery throughout the biennium.
- Property tax values increased slowly in the 1990s but fell in fiscal 2000 and 2001, primarily due to legislative tax changes. Estimates for the 2005 biennium show a resumed slow upward trend. The effects of the reappraisal cycle have not been included in the HJR2 revenue estimates.
- Interest rates dramatically declined beginning in January 2001, but rates are expected to begin an upward trend during the forecast period as the national economy recovers.
- Estimates show a slow decline in the prices of coal, natural gas, and oil during the forecast period. If a U.S. war with Iraq materializes, energy prices could mushroom during the conflict.

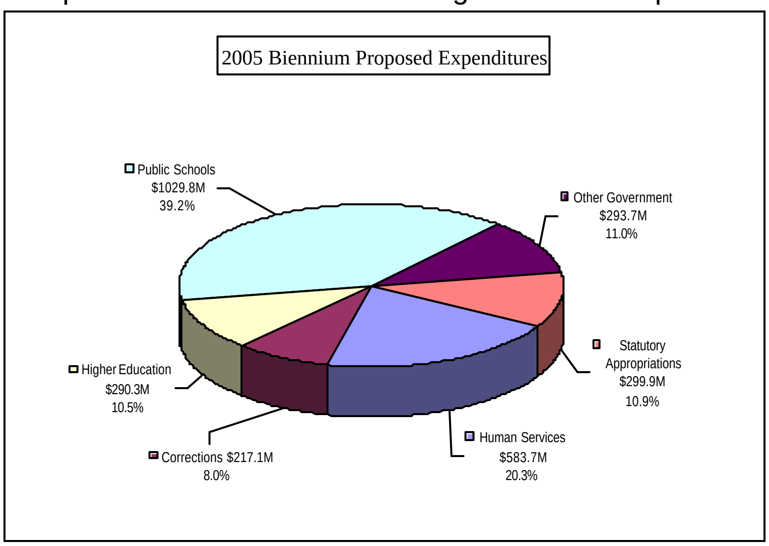
GENERAL FUND EXPENDITURE IMPLICATIONS

Montana's expenditure growth, like revenue growth, is responsive to economic and demographic conditions. While income levels, commodity prices, and interest rates influence revenue trends significantly, expenditure trends are more susceptible to population trends and demographic characteristics. Inflation rates also significantly impact expenditure trends, but are not a good overall measure of expenditure trends.

As discussed previously, total population growth trends in recent years have abated from historical levels and are expected to grow at only 0.9 percent per year throughout the next biennium. Even with a slower growth rate, the demand for state services continues to increase. Depending on the demographics (age, income, etc.) of the population base, the demand for government services will emerge in the form of increased school enrollments, caseloads, or government employee workload. Demographics play a significant role in determining the cost of governmental services. With a shift in age demographics, school populations have declined while human services and corrections populations have grown. "Baby boomers" will continue to place increased pressures on government social programs as they enter their senior years. And in general, economic downturn results in higher demand for government services, exacerbating budget woes in times of declining revenues.

Additionally, Montana is a large state with a sparse population. One implication of this characteristic relates to how its citizens access government. Some state programs, because of the nature of their services, must maintain a presence in numerous communities in order to ensure access. Others have used information technology to provide citizens with access to governmental services. Merely providing government access will require either more services provided locally or the expansion of information technology capabilities.

The pie chart to the left shows the general fund expenditures, as proposed for the 2005 biennium in the executive budget. As shown, education (K-12 and higher education), human services, and corrections comprise 78 percent of the general fund budget. These components are driven by demographics, population, and other factors that drive caseload, student enrollment, and prison population. The statutory appropriations component is predominantly local government assistance and debt service on state indebtedness. All other parts of state government (over 20 agencies) comprise only 11 percent of the general fund budget.



General Fund Economic Implications – Summary

In summary, revenue growth is expected to slowly recover in the 2005 biennium from the significant declines in the 2003 biennium. However, this rate of growth is not expected to be nearly as strong as observed during the late nineties. This premise is based on slower growth in income tax revenues with a property tax base that is increasing but still below the fiscal 2000 level. Capital gains income is not expected to return to the historic levels of the late nineties, signifying a permanent loss of revenues.

The cost of governmental services will continue to increase even with a moderate rate of inflation and a slow growth rate in total population. School enrollments are declining, yet costs to support public schools continue to increase because of the relative weight of labor costs. Human services costs will continue to escalate because of greater caseload demands and higher medical costs.

Overall, the budget picture is serious when viewed from a perspective of funding existing services. This means there are insufficient revenues to fund present law services and leave an adequate ending fund balance or reserve. The legislature will be faced with significant challenges to balance the budget while ensuring long-term structural balance and to address the issues of economic development, educational funding, tax reform, and rising human services costs.

GENERAL FUND STATUS

The previous sections described the economic outlook for Montana and how those economic conditions determine the state fiscal outlook. This section looks at the specific general fund projections for the current biennium, and ultimately the size of the 2005 biennium budget, in view of the existing and forecasted economic conditions.

BUDGET SHORTFALL: HOW WE GOT HERE

For nearly a decade, states enjoyed a strong state budget picture. In the late nineties, the underestimation of capital gains taxes due to robust equity markets was the norm and contributed to a significant increase in state surpluses. States however, were caught off guard when the national economy went into a recession in early 2001, further aggravated by the unpredictable events of September 11. States with sales taxes and large manufacturing sectors felt the impact first, while states like Montana, with a high dependence on income taxes, did not feel the full impact until calendar 2002. The mild recession on the national level has hit states much harder than the more severe recession of the early 1990s. This is explained by the ever increasing proportion of state revenues realized from capital gains taxes during a period of unprecedented growth in equity markets. While some budget experts anticipated a slowdown in capital gains revenues, very few expected revenues would decline so severely. Montana’s state budget decline has been below the national average, yet there has been a dramatic reduction in revenues that did not become fully apparent until the filing of income tax returns reached its peak in mid-2002.

In November 2001 and in a series of reports since then, this office reported to the legislature that Montana was experiencing a sharp decline in general fund revenues. In April 2002, the Governor’s Office formally announced concerns about a budget deficit, and initiated proceedings to implement spending reductions in accordance with 17-7-140, MCA. On June 22, the Governor directed spending reductions of $23 million and at the same time called for a special session of the legislature to deal with a budget deficit.

The following discussion provides pre-special session projections of the general fund deficit, a summary of legislative actions taken, and the revised projected ending fund balance for the 2003 biennium.

2003 BIENNIUM – DEFICIT/SOLUTIONS

The 57th Legislature adjourned the 2001 session with a 2003 biennium budget that provided for a projected general fund reserve of $54 million (2.3 percent of biennial appropriations). The revenue estimates assumed a less robust growth pattern than immediate past biennia, but still a consistent growth. For the first several months following the 2001 session, state general fund revenues came in even stronger than projected in the revenue estimate resolution for fiscal 2001, resulting in $62 million more than anticipated. Revenues then held steady in early fiscal 2002. In November 2001, our office reported a significant downturn in general fund revenues and in the last half of fiscal 2002, revenues dropped off from regular session estimates by $153 million. Individual and corporate income taxes were the reason for the shortfall, dropping off by $123 million and $33 million, respectively, while all other revenue components combined were up a net $3 million. Although cushioned by an unexpected surplus in fiscal 2001, the revenue shortfall left a gap of $90 million, and placed the projected balance in a deficit situation.

Facing a projected ending fund balance of what ultimately turned out to be a negative $42 million, the Governor directed statutory spending reductions of $23 million, and called the legislature into special session to fill the remaining gap to achieve an acceptable ending fund balance reserve. The legislature adopted $59 million in budget balancing actions, leaving an ending fund balance projection of $40 million. Allowing a reserve of $13 million for the 2003 session costs and anticipated supplementals, the projected ending fund balance was $27 million. This was approximately $1 million above the statutory minimum fund balance of $26 million as specified in 17-7-140, MCA.

The solutions in the special session included a number of one-time solutions and a number of reductions that would only become permanent if acted upon by the 2003 legislature (i.e., they still remained a part of the budget base).

2005 BIENNIUM – PROJECTED DEFICIT

Utilizing a high fund balance combined with the Governor's and legislative reductions provided a short-term solution to the general fund shortfall in fiscal 2003. It was clear at the time, however, that falling revenues and an on-going expenditure base for government services that exceeded projected revenues would leave a significant 2005 biennium deficit for the 58th Legislature. The 2001 legislature had approved a budget in regular session that was structurally imbalanced – that is, the ongoing expenditure base exceeded projected revenues by over $50 million. This shortfall, combined with the sharp decline in projected revenues, left a large deficit when comparing available revenues to the cost of continuing present law services.

As shown in Figure 1 on the next page, the projected present law ending general fund balance for the 2005 biennium is a negative $232.0 million, which includes a $50.1 million ending fund reserve. This estimate is based on revenue estimates as adopted by the Revenue and Transportation Interim Committee on November 19, 2002, and the cost of operating state government based on present law requirements as derived from the Executive Budget. This projection provides a stark contrast to the $53.8 million balance the 2001 legislature originally anticipated at the end of the 2003 biennium, and leaves insufficient funds to even continue existing programs and services at present law levels. The primary reasons that have contributed to this outlook are a significant decline in actual and projected general fund revenue collections (primarily individual and corporation income taxes) and an increase in present law human service, corrections, and other costs.

Figure 1
2005 Biennium General Fund Balance
Present Law Only
In Millions

	Estimated 2005 Biennium
Beginning Fund Balance	**$4.357**
Revenues	
Current Law Revenue	2,526.709
Total Funds Available	**$2,531.066**
Disbursements	
General Appropriations	
Human Services	583.665
Corrections	217.133
Higher Education	290.256
Public Schools	1,029.848
Other Government	293.699
Statutory Appropriations	268.118
Non-Budgeted Transfers	31.780
Feed Bill Appropriations	6.699
Anticipated Reversions	(8.191)
Total Disbursements	**$2,713.007**
Ending Fund Balance Before Reserve	**($181.941)**
Proposed Executive Budget Reserve	**($50.060)**
Projected Present Law Deficit	**($232.001)**

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 and 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.

It is clear that anticipated funds will not support continuation of existing present law services. By statute, the executive must develop a present law budget in addition to new initiatives and/or reductions that fulfills the constitutional mandate of a balanced executive budget proposal. The executive budget proposal includes a number of new proposals that provide additional general fund revenue but also reduces the level of services provided by governmental entities The combined impact of these proposals eliminates the present law deficit and leaves the general fund balance at $36.0 million by the end of the 2005 biennium.

It has become clear that the state general fund tax base has declined, primarily with regard to individual and corporate income tax revenues. The prevailing question is how soon and to what extent the tax base will recover. It is now clear that the revenue bubble from capital gains income growth has burst, resulting in a permanent reduction in the general fund revenue base. In order to avoid a continued structural imbalance, the legislature will have to focus on long-term solutions to the current budget deficit.

A more detailed discussion of the general fund deficit is on page 45 of this volume.

How does the executive propose to solve the deficit?
What are the key features of the executive budget?

EXECUTIVE 2005 BIENNIUM BUDGET HIGHLIGHTS

INTRODUCTION

As outlined in the preceding sections, a revenue shortfall and budget deficit of $232 million face the 58th Legislature, as receding revenues do not leave enough to continue even present law services. This section turns to the Governor's proposed budget solutions, and is divided into two parts:

- Governor Martz's response to the state fiscal outlook -- that is, an overview of how the Governor proposes to eliminate the present law deficit, which is presented in more detail in the "Executive Budget Analysis" (page references are provided in Figure 2 on the next page).
- A brief highlight of Governor's Martz's policies and priorities in building the state budget for the 2005 biennium.

DEFICIT REDUCTION PROPOSALS

Figure 2 provides a summary of the budget balancers proposed in the Executive Budget that are intended to resolve the $232 million deficit and provide for a balanced budget for the 2005 biennium.

As shown in Figure 2, the executive budget includes $218 million in deficit mitigation measures (budget balancers) to resolve the $232 million deficit. The $232 million deficit projection assumes a $50 million ending fund balance reserve, and since budget balancers are $14 million less, the ending fund balance would only be $36 million (the difference of $14 million is largely due to lower revenue estimates adopted by the Revenue and Transportation Interim Committee in HJR 2, which were used to calculate the $232 million deficit).

The $218 million in budget balancers (shown in the shaded area of Figure 2) include a net $102 million in expenditure measures and $115 million in revenue solutions. Transfers from other funds, such as the coal tax trust transfer, are included as revenue solutions.

The most significant budget balancers are:

- $103.5 million in transfers from other funds, including the coal tax trust and state fund
- $21.1 million in fund switches
- $38.6 million in identified service reductions
- $58.3 million in miscellaneous and unspecified reductions
- (i.e., the executive does not generally identify what services will be reduced or the impact of the reductions)

Figure 2
Executive Proposed Deficit Mitigation Measures
2005 Biennium
(millions)

Component	Detail Subtotal	Total	Page Number
Projected Deficit		$ (232.0)	45
Ending Fund Balance Target Included in Projection		50.1	
Deficit Without Ending Fund Balance Projection		$ (181.9)	
BUDGET BALANCERS			
Revenue Proposals			
Fund Balance Transfers		$ 103.5	
State Fund	$ 17.3		75
Permanent Coal Tax Trust (net of interest impact)	86.3		79
Diversions to the GF - Extend Coal, Oil & Gas, Metal Reallocations*		8.3	77
Oil and Gas Accrual		3.0	78
Terminate Infrastructure Credit		2.0	79
Coal Tax Trust Reallocation		(0.5)	77
Revenue Reduction due to Expenditure Proposals		(0.9)	85
Total Revenue Measures		**115.4**	
Disbursement Proposals			
Cultural and Aesthetic Grants		(0.5)	E-56
Eliminate Current Transfers from the General Fund		14.4	
Transportation (for Motor Vehicle Div.)	6.0		76
Research and Commercialization/Growth Through Agriculture*	8.4		76
Pay Plan Proposal/Personal Services Contingency		(9.7)	95
HB 2 Reduction Measures		120.6	
Fee Increases	2.7		106
Funding Switches	21.1		109
Specific Service Reductions	38.6		105
Miscellaneous/Other Unspecified Reductions	58.3		70, 122
HB 2 New Proposals (positive)		(22.2)	
Total Disbursement Measures		**$ 102.6**	
Total Executive Deficit Mitigation Measures		**$ 217.9**	
Projected Actual Ending Fund Balance - Executive Budget		$ 36.0	

*Some reductions in service will also result.
**The executive offset enrollment increases with a like reduction in the same decision package. If the enrollment had been appropriately added in present law and reduced in a new proposal, the resulting unspecified reduction would total $25.4 million.

A page reference at the right of each item listed in Figure 2 directs the reader to a further description of each item.

GOVERNOR'S BUDGET POLICIES AND PRIORITIES - HIGHLIGHTS

This section provides a brief overview of the overall budget policies and priorities in the Martz budget to fund state government. Revenue proposals are discussed in more detail in the "Executive Revenue and Tax Policy Proposals/Issues" section on page 75 and expenditure proposals are summarized in the

"Executive Expenditure Proposals - Summary" section on page 63. Following are highlights of key issues of the budget.

Total Budget Summary

The Executive Budget proposal totals $6.8 billion for all funds, of which $2.6 billion is general fund. The executive includes total spending increases for the 2005 biennium (as compared to the 2003 biennium) of $45.4 million general fund and $471.5 million total funds (as adjusted for a fund switch for K-12 education). This represents biennial increases of 1.8 percent general fund and 7.5 percent total funds. General fund is distributed as follows:

- 50 percent goes to education (K-12 and higher education)
- 20 percent goes to human services
- 8 percent goes to corrections.
- 11 percent goes to local government assistance, debt service, and other statutory appropriations
- 11 percent goes to all other government (over 20 agencies)

Highlights Of Revenue Proposals

The Executive Budget includes over $100 million in revenue proposals, which are almost exclusively for the purpose of generating general fund savings/new revenue.

- There are no tax proposals in the Executive Budget that address tax policy or new initiatives (except for the Governor's proposed income tax/sales tax reform package, which is not part of the published Executive Budget)
- The revenue proposals are largely one time sources of funds intended to generate general fund savings, and include:
    - Extending a number of temporary revenue actions enacted by the legislature in the August 2002 special legislative session to help balance the general fund budget
    - Transfers from other funds, including the coal tax trust and state funds ($110 million)

Highlights Of Expenditure Proposals

The 2005 biennium executive expenditure proposals are defined by a series of additions and reductions in varying sizes and impacts among all agencies. Few functions of state government are eliminated or significantly reduced, and these are primarily concentrated in human services programs. LFD staff has attempted to ascertain anticipated impacts on services in the narratives related to specific agencies in Volumes 3 and 4.

The following summarizes the primary factors of the HB 2 (general appropriations act) portion:

- General fund increases by a net $54.5 million from the 2003 biennium -- The increase is dominated by funding for costs of state assumption of district courts and by population increases in corrections.
- Present law changes are dominated by three factors:
    - Increases for statewide present law adjustments (including full funding of personal services less vacancy savings, fixed costs, and inflation)
    - Caseload and enrollment changes
    - Reductions to continue the Governor's 17-7-140 spending reductions.

- General fund new proposals are dominated by reductions to meet general fund reduction targets within individual agencies. New proposal *increases* add a total of $22.2 million general fund, but are dwarfed by reductions of $86.9 million.
    - General fund new proposals for reductions lack a clear executive policy specification.
    - New proposal increases are:
        - To replace funding and address caseload increases in foster care
        - For developmental disabilities services (in part due to federal funding reductions)
        - To provide $6.0 million for schools.
- Program funding highlights include the following:
    - Human services would receive a relatively low, 1.1 percent general fund increase, reflecting otherwise significant caseload and health care cost increases that are offset by extensive budget balancing benefit reductions
    - An overall slight reduction in general fund/state special revenue spending for K-12 education in the 2005 biennium, reflecting declines in ANB, but allowing averaging of ANB in fiscal 2005 and other education policy initiatives
    - Higher education is held to virtually the same level of general fund as for the 2003 biennium, while total funds decrease $5 million – No increases are provided for enrollment growth or other present law adjustments
    - Corrections receives a $15 million, 7.5 percent increase, largely for population increases
- FTE increase by a net of 110.02 FTE in fiscal 2004 and 56.84 FTE in fiscal 2005 -- This total is the net after reductions in a number of agencies (156.87 FTE in fiscal 2004 and 213.00 FTE in fiscal 2005) -- Decreases are primarily general funded positions and increases are primarily positions funded from other funds.

There are other components of the executive proposal, not included in HB 2:

- Local government entitlements increase by $7.5 million for inflation, and do not participate in state shortfall cutbacks
- The employee pay plan (HB 13) includes only an increase in the state's share of the employee health insurance at a cost of $8.5 million general fund and $11.7 million other funds.
- Supplemental appropriations requests for fiscal 2003 (HB 3 and HB 16) total $14.5 million general fund, with a $1.2 million contingency not in the bills, but in the executive balance sheet.
- Statutory appropriations and local assistance have a total estimated cost of $394 million.

What are the major fiscal challenges facing the 2003 Legislature?
What are the Executive solutions?
What are the significant issues identified by the LFD analysis?

MAJOR FISCAL CHALLENGES / SOLUTIONS / ISSUES

As discussed previously, the 2003 legislature will convene facing the worst budget deficit in years. Revenue forecasts indicate insufficient revenues to support even present law expenditures, let alone the pressures of increased caseloads, growing prison populations, and demands for more money for schools. The volatility of revenues and an expected slow economic recovery add to an already dismal scenario for the 2005 biennium. What makes this shortfall worse than others is that most of the “easier” solutions were used in the fiscal 2003 Governor’s Spending and August 2002 Special Session reductions.

Therefore, it appears that the upcoming legislature will face many challenges in their deliberations. To put the economic and fiscal picture presented in prior sections in perspective, the following summarizes key challenges and uncertainties that they will have to consider in formulating the 2005 biennium spending plan and related fiscal issues. Below each is a summary of the executive proposed solution and issues raised by the LFD analysis where appropriate.

Fiscal Challenge

A significant budget deficit will leave the 58th Legislature with a projected shortfall that falls $232.0 million short of the amount needed to continue present law services. The legislature will have to either significantly reduce existing government services or provide additional revenues to fund existing services.

Executive Proposal: The executive budget proposes a combination of $102.6 million in expenditure reductions and $115.4 million in revenue adjustments to fund the 2005 biennium budget. The revenues include the transfer of a net $86.3 million (net after interest lost) from the Coal Tax Trust Fund and $17.3 million from the State Compensation Insurance Fund (“old fund”).

Issue: The executive budget as proposed would provide for a balanced budget, but would require a 3/4 vote of the legislature to authorize the transfer from the Permanent Coal Tax Trust. Although several attempts have been made to transfer these funds for direct operational expenditures, none have ever been successful.

Issue: At least $50 million in proposed expenditure reductions lack specificity in what service or operations reductions would be necessary or the impacts. This denies the legislature the information necessary for determining policy and prioritizing services.

Fiscal Challenge

Economic uncertainties continue to undermine revenue-forecasting efforts, and contribute to an increased demand for government services in the areas such as human services and corrections.

Executive Proposal: Although there is a great deal of concern about the ability of general funds to recover in the near term, the executive budget assumes a relatively strong recovery by fiscal 2005. On the program side, the executive proposes approximately $38.6 million in specific services reductions and another $58 million in unspecified reductions, with significantly reduced eligibility and benefits in health care services.

Issue: Given the signs of a sluggish national economy and the inherent increase in government services demands and eligibility, are revenue estimates conservative enough, and can tight budgets in human services and corrections be sustained without cost over-runs?

Fiscal Challenge	**Adequacy of the ending fund balance** reserve will need to be evaluated by the legislature in the wake of reduced revenue growth and budget balancing reductions. What will it take to ensure that Montana has an adequate "safety net" in place?

Executive Proposal: The Executive Budget includes a general fund ending fund balance at the end of fiscal 2005 of $50.1 million, or about 1.9 percent of total proposed general fund appropriations. Using HJR 2 revenue estimates, the executive budget leaves a balance of only $36 million.

Issue: In consideration of economic uncertainties and the lack of a budget for wildfire suppression, the LFD suggests 2.5 percent of ongoing revenue reserve as a minimum, which would translate into a $65 million ending balance. National fiscal experts recommend a balance of 3 to 5 percent. Besides the typical reserve, another possibility is establishment of a "rainy day" fund as used in 46 other states.

Fiscal Challenge	**Controlled budget growth (structural balance)** will continue to be a concern if revenues fall short of expectations and "one-time revenue" fixes are used to fill gaps in the shortfall. A widening structural imbalance can translate into continuing budget problems for the legislature in future biennia.

Executive Proposal: The executive proposal would leave a projected structural imbalance in fiscal 2005 of $34 million (ongoing expenditures exceed ongoing revenues).

Issue: With the likelihood that state revenues will not experience similar growth rates of the late nineties, the legislature should consider long-term solutions to provide a permanent solution to the budget shortfall.

Fiscal Challenge	The **fiscal 2003 budget shortfall**, although addressed by the August special session, is not completely resolved. A combination of revised revenue estimates, higher than expected supplemental requests, and the passage of a voter initiative will reduce the 2003 projected ending cash and fund balance to a dangerously low level.

Executive Proposal: The executive projects an ending fund balance in fiscal 2003 of approximately $6.0 million, whereas the LFD projects a $4.4 million ending fund balance. This balance falls well short of the required statutory minimum fund balance of approximately $26 million.

Issue: The legislature needs to examine whether additional budget balancing action will be required to provide an adequate ending cash and fund balance for the current 2003 biennium.

Fiscal Challenge

Health care cost inflation and caseload increases continue to be major contributors to greater than average growth in health care services budgets. Double-digit increases in state health care costs are back after several years of moderate growth. Significant service reductions were implemented in fiscal 2002 to stay within budget, and budget reductions in fiscal 2003 provided more service cutbacks. Underestimating costs could result in a budget-breaking supplemental request or further reductions in health care services.

Executive Proposal: The executive budget includes significant services reductions, tighter eligibility criteria, and the refinancing of some services. The $5.7 million general fund increase (0.6 percent) over the 2003 biennium is the net of adjustments for increased costs and caseload, offset by reductions in program operations and services. Increases in other funds of nearly $217 million are primarily federal funds that relate to various programs such as Medicaid, food stamps, and bio-terrorism grants.

Issue: The major issue facing the legislature is structuring Medicaid funded programs to serve the most needy, vulnerable citizens, while limiting cost increases. The difficulties lie in choosing policies that:

- Do not shift costs to other entities, including functions that are 100 percent funded by the general fund or to counties
- Do not shift costs to other potentially more expensive components of the Medicaid program
- Are within federal criteria to maintain federal Medicaid participation
- Are equitable

Increasing health care costs impact other areas of the budget as well, such as the cost of employee health insurance and health care costs in institutions.

Fiscal Challenge

Correctional system population continues to grow. Underestimating the growth could result in a budget-breaking supplemental request, and overestimating could skew the prioritization process, taking funding away from other program areas. In addition, a recent strategy of early release of prisoners, while providing some budgetary relief, might not result in the savings that was desired.

Executive Proposal: The executive budget proposes for corrections a $14.7 million or 7.5 percent increase in general fund for the 2005 biennium. This is one of the largest general fund increases (dollars) in the Executive Budget. To date, no supplemental appropriation for fiscal 2003 has been requested for the Department of Corrections.

Issue: Managing this budget relies on continuation of conditional release strategies, which are accompanied by citizens' perceptions of public safety issues. The impacts of reductions to inmate services are unknown.

Fiscal Challenge

Funding for schools is an ongoing concern. In recent years, public schools have been faced with declining K-12 enrollments and declining budget authority without equal reductions in costs. What steps can the state take to help resolve school funding problems and maintain its relatively high achievements in performance measures?

Executive Proposal: The executive proposal addresses declining enrollments and the problem of declining budget authority by proposing an increase in school district entitlements of 2 percent and 1 percent in fiscal 2004 and 2005. In addition in 2005, the executive proposes to allow districts to average ANB (Average Number Belonging) over a three-year period to mitigate the effects of declining enrolments.

Issue: ANB is expected to decrease about 3.4 percent over the two years of the biennium, lower than the proposed increase in entitlements of a little over 3 percent. The executive's proposal partially pays for the entitlement increase with a reduction in the direct state aid percent to 42.6 percent from 44.7 percent, thus increasing mandatory BASE aid taxes in the district general fund.

Fiscal Challenge

Higher education has been funded to a greater and greater degree in recent biennia with increased tuition charges, as general fund becomes a smaller share of total funding. The legislature will need to reconcile the difference between what the total state funded share of higher education should be, and what the state can afford during these times of revenue limitations.

Executive Proposal: The proposed 2005 biennium Executive Budget for state support of higher education, at $273.4 million, is $3.8 million less than the 2003 biennium base (fiscal 2002 adjusted expenditures times two) and is as much as $40 million less than the present law level acknowledged by the executive before application of budget balancing reductions.

Issue: The reductions in the executive budget are unspecified, and abandon the per student formula that has been used in the past. The reductions are not tied to the statewide policy goals and accountability measures adopted by the Subcommittee on Postsecondary Education Policy and Budget. The level of funding in the Executive Budget may again lead to tuition increases.

Fiscal Challenge

State assumption of district courts has become a difficult issue for the Judiciary. The implementation of SB 176 (2001 session) has left many questions about who (state or local jurisdictions) should be paying for what. The fiscal 2002 base contained no district court expenditures, so a full biennium cost must be added to the 2005 biennium budget.

Executive Proposal: The executive recommended 2005 biennium budget for district court assumption is $37.3 million, an amount that is dependent upon passage of legislation making counties responsible for variable costs above the appropriation.

Issue: The funding issue primarily pertains to the state's limited ability to control or predict those costs that vary with caseload, including juror fees, witness fees and expenses, and indigent defense costs in criminal felony cases. In addition, unanticipated costs of salary increases, rent, the judicial branch pay plan, and operating expenses of new judges in Ravalli and Cascade counties have also contributed to a higher fiscal 2005 biennium budget.

Fiscal Challenge

Local government assistance was restructured by the 2001 legislature, in an effort to provide stable revenue sources for local programs. Local government, however, is not necessarily immune to the budget woes of the state or the economic turmoil of the state and nation.

Executive Proposal: The executive proposes no change to current law in HB 124 entitlements to counties and cities, but proposes to delay the current law increase in HB 124 block grants to school districts and the countywide education accounts for two years. In addition, HB 124 block grants to district transportation and school facility accounts will be reduced.

Issue: County and city HB 124 entitlements will be $7.5 million higher in the 2005 biennium than in the 2003 biennium. Under the governor's proposal, HB 124 block grants to schools will drop around $12 million, although nearly all of this will be redistributed to districts based on number of students or on school facility debt service needs. The legislature needs to consider how this proposal fits with other budget balancing priorities.

Fiscal Challenge

Economic development has been a high priority for the Martz administration. As the state attempts to address its economic climate, budget woes are causing state investments in economic development activities to shrink, while Montana continues to rank near the bottom in per capita income and other economic indicators.

Executive Proposal: $8.4 million general funds and $9.4 million other funds is proposed by the executive for economic development programs in the Governor's 2005 biennium budget. This includes an $8.0 million general fund decrease and a $1.3 million decrease in other funds as compared to the current biennium. Most of the general fund decrease occurs in the elimination of a statutory allocation of monies for research and commercialization grants.

Issue: The legislature needs to consider whether an investment in economic development is a high priority. If successful, the investment could be a partial solution to the current budget crisis by providing more stimulus for economic recovery. It is also important to assess the effectiveness and whether these investments are producing cost benefits.

Fiscal Challenge

Potential **loss of federal funds** can occur in any instance where the state is forced to make budget cutbacks, especially when a significant share of general fund dollars are used as a match for federal funds. The loss of federal funds translates to reductions in services to citizens, loss of jobs in the state, and loss of "imported" money into the Montana economy.

Executive Proposal: The Executive Budget includes $23.2 million in general fund reductions that result in federal fund reductions of $45.5 million for the biennium. Most of these impacts occur in the Department of Public Health and Human Services.

Issue: The legislature needs to consider the impact of reduced federal matched funds when prioritizing budget options in resolving the current deficit.

Fiscal Challenge **Supplemental emergency appropriations** for the next biennium are not budgeted for by the legislature and not accounted for in the ending fund balance. The state continues to experience supplemental appropriations each biennium, particularly for fire suppression.

Executive Proposal: The 2005 biennium executive budget does not include an amount set aside for supplemental appropriations in anticipation of "potential" expenditures, although it does call for a significant increase in the emergency appropriation, from $12 million to $25 million. This appropriation is not included in their projected ending fund balance.

Issue: The state has historically experienced some chronic emergency costs and caseload induced cost overruns. For example, the state has experienced perennial fire costs, ranging from $0.8 million to $39.4 million over the last 11 biennia, and averaging nearly $10 million per biennium when the highest and lowest are excluded. Even though fires are not predictable events, it would be prudent to reserve funds to cover such reoccurring items. At a minimum, the legislature should consider the potential for future supplemental appropriations when determining an appropriate ending fund balance.

Fiscal Challenge **Pending litigation** can impact state finances. Currently, there are two legal actions pending that seek changes and increased funding for services for the developmentally disabled: the Montana Advocacy Program (MAP) Travis D. class action lawsuit, and the Montana Association for Independent Disability Services, Inc. (MAIDS) lawsuit. There is also a lawsuit challenging adequacy of state funding for schools.

Executive Proposal: The executive proposes increased funding for developmental disabilities programs by $7.7 million general fund and about $18.4 million total funds, and uses general fund monies made available due to "refinancing" efforts to strengthen and expand services.

Issue: A conservative estimate of the potential additional costs of services for developmentally disabled individuals if the state is not successful in defending against these legal actions is $20 million.

Executive Proposal: The executive proposes to hold state support to schools at fiscal 2002 levels over the 2005 biennium.

Issue: In September 2002, a suit was filed in Montana's first judicial district court against the state of Montana alleging that the state has not adequately funded its K-12 school system. The suit will be heard sometime after the first of the year in calendar 2004. State support for school district costs as a percent of total district funding is very likely to decline further under the executive budget proposal.

What Other Fiscal Issues are important to consider?

OTHER FISCAL ISSUES

INTRODUCTION TO OTHER FISCAL ISSUES

The Legislative Fiscal Division analysis also includes several fiscal issues not directly related to the Executive Budget, but that will potentially have an impact on the budget passed by the legislature and/or the budget process. These fiscal issues are varied and sometimes complex. It is important that the legislature be aware of them in its deliberations. The following briefly describes each issue. These issues are described in more detail later in this volume under the title, "Other Fiscal Issues to Consider." Page references are provided for each issue.

- **Tobacco Settlement Funds.** Montana receives revenue as a settling party to a Master Settlement Agreement. Of $57.2 million expected in the 2005 biennium, 40 percent is earmarked for the Tobacco Trust, 32 percent funds tobacco prevention programs, and 17 percent funds the Children's Health Insurance Program. The remaining 11 percent is to be deposited in the general fund. Anticipated interest earnings of $5.7 million from the trust must be allocated 10 percent to the trust and 90 percent as appropriations for disease prevention and programs providing benefits, services, or coverage related to the health care needs of Montana citizens (Page 125)

- **District Court Assumption**. Under SB 176, the district courts, with the primary exception of the clerks of court and the provision of office space, became a state-funded function. Beginning in fiscal 2003, the state Judiciary assumed responsibility for oversight and administration of the 22 courts, including approximately 245 additional FTE. Implementation was accomplished through the efforts of the District Court Council, provided in SB 176 (2001 regular session), along with Judiciary staff. During this time and since implementation, the council and branch have encountered issues with SB 176 and continue to advocate that the bill was under-funded. The executive recommends $37.3 million for the 2005 biennium budget for district courts administration. (Page 126)

- **Statutory Appropriations**. Expenditures from statutory appropriations in the 2005 biennium are estimated at $268.1 million, an amount significantly higher than for biennia prior to passage of HB 124 in 2001. Entitlement payments to local government account for $167.2 million. These appropriations become a greater concern, as the amount of money appropriated does not automatically get reviewed by the legislature. (Page 129)

- **General Fund Transfers**. Transfers of $1.8 million from the general fund to other funds in the 2005 biennium, are markedly higher than in biennia that preceded HB 124, enacted in 2001. Like statutory appropriations, these transfers and their authorizations are in statute and are not part of the biennial budgeting process, meaning that the monies are not part of the budget prioritization process to the same extent as other general fund monies. (Page 132)

- **General Fund – Cash Position**. The projected general fund ending cash position for fiscal 2003 is at a historical low point. The importance of the cash position is significant and sufficient cash is required to pay the state's budgeted obligations. At this time the general fund ending balance for fiscal 2003 is estimated at $4.4 million. Of that balance, there is an approximate $5.0 million differential between the ending fund balance and the cash balance of the general fund. This suggests that at the end of fiscal 2003, the general fund may have a negative $0.6 million ending cash balance. (Page 134)

- **Local Government Assistance Restructuring**. Beginning in fiscal 2002, HB 124 reallocated revenue to the state that had formerly gone to local jurisdictions. The local revenue was replaced by creating entitlements for counties and cities. Entitlements for counties, cities and consolidated governments will be $7.5 million higher in the 2005 biennium than in the 2003 biennium. These rates of growth exceed the expected rate of growth in state revenues for the 2005 biennium. (Page 136)

- **Mental Health Services: Interim Study**. A subcommittee of the Legislative Finance Committee (LFC) focused on the commitment process to the Montana State Hospital and to community services, and transitions to intensive services in the community. The LFC recommended five pieces of legislation. (Page 138)

- **Fund Balance Adequacy/Reserves**. Ensuring that there are sufficient revenues to fund state programs is one of the responsibilities of the legislature. The legislature's challenge is to ensure that there is an adequate fund balance reserve to protect the state spending plan from unexpected events. (Page 140)

- **Accruals**. Agencies booked general fund accruals totaling $18.3 million in fiscal 2002, which are part of the 2002 biennium base. The LFD questions $240,000 of these accruals and whether they can be removed from the budget. (Page 142)

- **Unified Computer Budget**. The Executive Budget for the 2003 biennium was the first budget to include a "unified computer budget" as specified in HB 2 of the 1999 session. Actual fiscal 2000 information technology (IT) expenditures were $77.9 million, or 10.1 percent of HB 2 operating expenditures. (Page 143)

- **Other Major Funds.**
  - *Highway Special Revenue Account*. The 2003 legislature is faced with a declining working capital balance in the highways state special revenue account. The account is projected to end fiscal 2005 with a working capital balance of $10.2 million, which is down from a $51.4 million balance at the end of fiscal 2002. Projections indicate that expenditures will exceed revenues by $21.0 million in the 2005 biennium, with the imbalance continuing in future biennia. (Page 146)

- *Resource Indemnity Trust*. During fiscal 2002, the Resource Indemnity Trust (RIT) exceeded the $100 million threshold. This will result in a redistribution of money that would otherwise have gone into the trust. In addition, of seven accounts that have historically received allocations of Resource Indemnity and Ground Water Assessment Taxes or Resource Indemnity Trust interest earnings, four are projected to have negative balances by the end of the 2005 biennium. The legislature will need to address the distributions of RIT funding streams to insure a balance between revenues and disbursements. (Page 146)

WE'RE NOT ALONE – OTHER STATES' BUDGET WOES

BUDGET SHORTFALLS

The decade of the nineties was a period of unprecedented economic growth in the United States, and state governments benefited from excellent fiscal conditions, where revenues generally grew above expectations while spending pressures declined for many large programs such as human services and education.

Now, however, nearly all states face a huge fiscal crisis. Revenues have dropped off dramatically, and total state tax revenue in fiscal 2002 was nearly $40 billion lower than in previous years (adjusted for inflation). Revenues in the nineties grew above expectations due to higher levels of economic activity and unprecedented capital gains realizations. While Montana did not really feel the effects of a recession, capitals gains had a huge impact. The revenue growth of the nineties turned out to be temporary, and likely unsustainable. Further, most states reduced revenue levels through tax cuts while building a higher expenditure base. The expectation in 2003 nationwide is to barely hold steady at the reduced revenue levels of 2002, and for only a slow, modest recovery beyond 2003. There is little optimism for a full return to pre-2001 revenue levels, and spending pressures from Medicaid and other health care costs are growing faster than in the nineties. The current crisis is seen as the worst state budget situation in over a half-century.

The revenue downturn has and will have a substantial impact on the level of government services. To date, nearly all states have avoided either major service reductions or tax increases by finding short-term solutions, budget transfers, and other "easy" solutions. But states are running out of options, and most 2003 legislatures will face severe deficits that require either significant tax increases, program/service reductions, or a combination of both. Revenue estimates reflect a resignation that the state revenues will not bounce back soon.

Comparatively, Montana's budget shortfall is slightly below the average for all states. In 2002, the states with the largest deficits were Alaska (a 20 percent shortfall), California, Arizona, Nevada, Oregon, Colorado, and neighboring Idaho. In the past two years, 47 states have had to deal with general fund shortfalls. Wyoming is one of the fortunate to have avoided the crisis.

SOLUTIONS

As stated previously, states have tweaked their budgets and found short-term fixes, hoping to avoid the inevitable. In fiscal 2002, all states avoided significant tax increases or program reductions. In fiscal 2003, states began reluctantly turning to tax increases and program reductions. Over the past two years, the most common solutions states have used to date include:

- Well over half the states have tapped their rainy day funds to fill the budget gaps -- A total of 46 states have rainy day fund provisions
- Nearly all states have implemented program reductions
  - Over half the states approved across-the board percentage budget reductions
  - Most states have implemented health care reductions, including Medicaid growth control (benefits and eligibility), provider payment reductions, and drug costs
  - Over half the states have had some state employee lay-offs, and at least five have enacted early retirement incentives
- 16 states implemented minor tax enhancements in fiscal 2002, while 24 have implemented tax increases in fiscal 2003 - this is a reversal of nearly a decade of tax reductions by states on average
  - 15 states increased cigarette taxes in fiscal 2002 and another 19 did so in fiscal 2003, by an average of nearly 50 cents per pack
  - 17 states increased sales taxes, 17 increased personal income taxes, and another 15 states increased corporate income taxes
  - Vehicle, motor fuel, and gaming taxes were changed by several states
  - Six states have implemented tax amnesty periods
- Nearly half the states have implemented fee increases on such items as driver's licenses, car registration, and gaming
- At least 14 states have sold part or all of their tobacco settlement future revenue streams for a one-time revenue source
- Most states have assessed local government a share of the budget cutbacks
- Other measures
  - Delay of building projects
  - Borrowing from other funds
  - Gaming expansion
  - Shifting of funds to federal or state special revenue