LEGISLATIVE BUDGET ANALYSIS

2007 Biennium

Volume 1 – Statewide Perspectives

Presented to the Fifty-ninth Legislature

Submitted by

The Legislative Fiscal Division

Helena, Montana

January 2005

MONTANA LEGISLATIVE BRANCH

Legislative Fiscal Division

Room 110 Capitol Building * P.O. Box 201711 * Helena, MT 59620-1711 * (406) 444-2986 * FAX (406) 444-3036

Legislative Fiscal Analyst
CLAYTON SCHENCK

December 2004

Members of the Fifty-ninth Legislature:

I submit for your consideration a fiscal analysis of the state budget outlook for the 2007 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 2007 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
  - The Legislative Fiscal Division's detailed descriptions and analysis of the various components of the Executive Budget

Our analysis will be updated in January to reflect any budget revisions submitted by Governor-elect Schweitzer.

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.

Special thanks to Director Chuck Swysgood and the
Office of Budget and Program Planning, as well as
agency directors and budget personnel
for their gracious cooperation
in this budget analysis effort.

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.

Thanks also to
Leona Olsen and staff
of the Publications and Graphics Bureau
for exceptional customer service
in publishing this report.

Questions and comments regarding this report
should be directed to:
Clayton Schenck, Legislative Fiscal Analyst
(406) 444-2986
cschenck@mt.gov

TABLE OF CONTENTS

Statewide Perspectives – Volume 1

TABLE OF CONTENTS
Continued

Executive Budget Analysis (continued)

Other Fiscal Issues to Consider

TABLE OF CONTENTS
Continued

Legislative Fiscal Division

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

LEGISLATIVE FINANCE COMMITTEE

Senator Keith Bales, *Vice Chair*	Representative Gary Forrester, *Chair*
Senator Rick Laible	Representative John Brueggeman
Senator Joe Tropila	Representative Rosalie Buzzas
Senator Jon Tester	Representative Dave Lewis
Senator Emily Stonington	Representative Dave Kasten
Senator Tom Zook	Representative Monica Lindeen

LEGISLATIVE FISCAL DIVISION

Clayton Schenck	Legislative Fiscal Analyst
Terry Johnson	Principal Fiscal Analyst
Taryn Purdy	Principal Fiscal Analyst
Jon Moe	Fiscal Specialist
Mike Allen	Information Technology
Roger Lloyd	Senior Fiscal Analyst
Jim Standaert	Senior Fiscal Analyst
Lois Steinbeck	Senior Fiscal Analyst
Greg DeWitt	Senior Fiscal Analyst
Pat Gervais	Senior Fiscal Analyst
Cathy Duncan	Senior Fiscal Analyst
Marilyn Daumiller	Associate Fiscal Analyst
Harry Freebourn	Associate Fiscal Analyst
Barbara Smith	Associate Fiscal Analyst
Alan Peura	Associate Fiscal Analyst
Shane Sierer	Associate Fiscal Analyst
Diane McDuffie	Office Manager
Cassie Rice-Wetzel	Administrative Support

HOW TO USE THIS REPORT

The *Legislative Budget Analysis, 2007 Biennium* is published in four volumes. The report is designed to assist the 2005 legislature in setting fiscal priorities and to help legislators reflect those priorities in the 2007 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:

- What is the state's fiscal condition?
- What are the major fiscal challenges facing the 2005 legislature?
- What are the key features of the executive budget?
- What other fiscal issues are important to consider?

The "State Budget Outlook" section on pages 1 through 27 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 2005 biennium and 2007 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 legislature;
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.

LEGISLATIVE FISCAL DIVISION (LFD)

State Capitol, First Floor, East Wing, Telephone 444-2986

STAFF ASSIGNMENTS

General Government & Transportation

Greg Dewitt (44-5392, Office #119)
- Secretary of State
- Transportation
- Revenue
- Administration
- Appellate Defender Commission
- Montana Consensus Council

Marilyn Daumiller (444-5386, Office #108B)
- Legislative Branch
- Consumer Counsel
- Governor's Office
- Commissioner of Political Practices
- State Auditor's Office

Health & Human Services

Lois Steinbeck (444-5391, Office #118)
Pat Gervais (444-1795, Office #117)

Natural Resources & Commerce

Barbara Smith (444-5347, Office #108J)
- Fish, Wildlife & Parks
- Environmental Quality
- Natural Resources & Conservation

Shane Sierer (444-2722, Office #108C)
- Livestock
- Agriculture
- Commerce

Corrections & Public Safety

Harry Freebourn (444-5834, Office #108I)
- Board of Crime Control
- Judiciary
- Justice
- Public Service Regulation
- Corrections

Shane Sierer (444-2722, Office #108C)
- Military Affairs
- Labor & Industry
- Education

Education

Marilyn Daumiller (444-5386, Office #110A)
- School for the Deaf and Blind
- Board of Public Education
- Montana Arts Council
- Library Commission
- Montana Historical Society

Education (cont.)

Alan Peura (444-5387, Office 108D)
- Commissioner of Higher Education/Board of Regents
- Community Colleges
- Six University Units and College of Tech.
- Agricultural Experiment Station
- Extension Service
- Forestry & Conservation Experiment Station
- Bureau of Mines & Geology
- Fire Services Training School

Jim Standaert (444-5389, Office #113)
- Office of Public Instruction

Cathy Duncan (444-4580, Office #131)
- Long-Range Building
- State Building Energy Conservation
- Treasure State Endowment
- Treasurer State Endowment Regional Water
- Renewable Resource Grant & Loan Program
- Reclamation & Development Grant Program
- Cultural and Aesthetic Grant Program

Revenue Estimating/Monitoring/Tax Policy

Terry Johnson (444-2952, Office #115)
Jim Standaert (444-5389, Office #113)
Roger Lloyd (444-5385, Office #120)

Public School Funding

Jim Standaert (444-5389, Office #113)

Information Technology

Mike Allen (444-4101, Office #130)

Support Staff

Diane McDuffie (444-2986, Office #110A)
Cassie Rice-Wetzel (444-2986, Office #110A)

Fiscal Specialist

Jon Moe (444-4581, Office #132)

Principal Fiscal Analysts

Terry Johnson (444-2952, Office #115) – Revenue
Taryn Purdy (444-5383, Office #114) - Budget

Legislative Fiscal Analyst & Director

Clayton Schenck, (444-2988, Office #116)

INTRODUCTION

After facing a period of severe revenue shortfalls, Montana is seeing a dramatic turnaround in some key revenue sources. Revenues from individual income and oil and gas taxes have increased significantly in 2004. Rather than beginning the 2005 session with a large deficit, as was the case in 2003, the legislature will start with a large projected fund balance as of the end of FY 2005. But the surplus is not necessarily what it appears to be, as a significant portion is from one-time, nonrecurring revenue. That means there is some risk in using these revenues for ongoing programs or services. In what is always a challenging fiscal environment, the 59th Legislature will be faced with an opportunity to shape a budget that addresses some of the state's ongoing fiscal issues while at the same time taking on some very daunting emerging fiscal challenges, including the school funding lawsuit.

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, and the projected general fund outlook. We then summarize the major fiscal challenges this legislature faces, the executive response/solutions to the challenges, as well as issues regarding those challenges/solutions. We also present summary highlights of the executive budget and the executive budget priorities. Other significant fiscal issues facing this session are also highlighted.

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 general fund outlook?
- What are the major fiscal challenges facing the 2005 Legislature?
- What are the executive solutions?
- What are the significant issues identified by the LFD analysis?
- What are the key features and priorities of the executive budget?
- What other fiscal issues are important to consider?

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?

ECONOMIC OVERVIEW

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.

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.

In some instances, economic strength can be a "good news / bad news" dilemma. For example, if total personal income increases significantly, this usually translates into higher individual income taxes. On the disbursement side, however, strong personal income growth can result in increased state general fund match amounts for the federal Medicaid program. If Montana's total personal income growth is unusually high when compared to the national average, the federal medical assistance percentage (FMAP) rate declines, thereby requiring the state's matching rate to increase. This situation is expected to occur during the 2007 biennium.

Employment and wage indicators continue to support stronger growth in the near-term, with the prospect of more average growth from calendar 2005 to 2007. While capital gains income rebounded in calendar 2003, net capital gain realizations are expected to increase only modestly during calendar 2005, 2006, and 2007.

During calendar 2001, the Federal Reserve Board (FRB) reduced interest rates 12 times in an attempt to stimulate the US economy. As the economy began to regain strength in calendar 2004, the FRB began increasing rates to insure stable growth with the goal of maintaining low inflation. Most economists project interest rates to increase through the 2007 biennium but to levels below historical averages. Short-term rates are not expected to exceed four percent, while long-term rates are expected to be close to six percent. The effects of higher interest rates may have some dampening impacts on economic growth to the benefit of increased state revenues from investments.

Even though interest rates have increased from historic lows, corporate profits are expected to increase significantly during calendar 2005 and increase modestly thereafter. Property values resumed an upward trend in 2003, and that trend is expected to continue through the 2007 biennium. Net taxable value growth in tax year 2006, however, is expected to be near 10 percent as several tax increment financing districts are eliminated.

After decades of reductions in oil production – from a peak in 1973 of 34 million barrels to a trough in 1999 of 15 million barrels – recent Montana production has increased. With higher prices, new drilling activity increased 75 percent in 2003, and has increased nearly the same amount in 2004. In calendar 2003, production was over 19 million barrels and will probably be near 22 million barrels in calendar 2004. Higher production is expected to continue.

Natural gas production in Montana doubled between 1981 and 2003 due to higher market prices, from 40 million MCF to 80 million MCF, with 75 percent of that increase since 1997. Newly drilled wells have contributed about 20 percent to total production since calendar 2000. As with the oil market, new drilling activity was up substantially in calendar 2003 and 2004. Higher production is expected to continue into the next biennium.

In summary, the economic outlook for the state is for moderate growth throughout the forecast period. This general premise of moderate growth is supported by testimony received on November 16, 2004. The Revenue and Transportation Interim Committee set aside part of a scheduled meeting to hear from Dr. Paul Polzin, Bureau of Business and Economic Research, and Dr. Myles Watts, Department of Agricultural Economics, Montana State University. Each of these economic experts provided the committee with their outlook on various aspects of the state and national economies.

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

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 2007 biennium budget.

GENERAL FUND REVENUE IMPLICATIONS

Montana's fiscal outlook for revenue growth is significantly more optimistic than the last biennium. The preliminary revenue estimates adopted by the Revenue and Transportation Interim Committee (HJR2) are based on moderate economic growth through calendar 2007, with slightly stronger growth for calendar 2006 at both the national and state levels. Figure 1 shows the comparative change by major revenue category, for an average increase of 4.8 percent over the 2005 biennium. For a complete discussion of general fund revenue projections by category, see the detailed explanation for each revenue component in Volume 2, "Revenue Estimates".

Figure 1

General Fund Revenue
By Major Category

Major Category	2005 Biennium Estimate Millions	2007 Biennium Estimate Millions	Percent Change
Individual Income Tax	1,193.986	1,234.869	3.42%
Corporation Income Tax	134.055	158.548	18.27%
Vehicle Tax	163.967	162.190	-1.08%
Investment Earnings	87.901	100.336	14.15%
Natural Resource Taxes	124.993	145.916	16.74%
Property Tax & Non Levy	339.582	358.486	5.57%
Insurance Tax	115.805	127.383	10.00%
Consumption Tax	240.558	247.732	2.98%
All Other Revenue	365.357	362.856	-0.68%
Total General Fund	2,766.204	2,898.316	4.78%

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. As discussed in the previous section, "Economic Overview", the outlook for the majority of these targeted assumptions is positive for Montana's economy. 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 detailed explanation for each revenue component is in Volume 2, "Revenue Estimates".

- Wage and salary income provides the largest portion of Montana total income. On average, wage and salary income contributes over 65 percent of total income. Average growth has been 5.5 percent from calendar 1990 to 2003. For calendar 2005, growth is expected to be 4.4 percent, and 4.5 percent in calendar years 2006 and 2007.
- 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, to 5.7 percent. Capital gains is projected to increase by 11.1 percent between 2004 and 2007, a compound growth rate of 2.7 percent annually.

- Average annual growth in employment between 1990 and 2003 has been 2.1 percent, although since 2000 the average rate of growth has been 1.1 percent. It is expected that employment growth through 2005 will remain at 1.2 percent and grow by 1.3 percent in calendar years 2006 and 2007.
- Population growth since the early 1990s has been positive, varying between 0.1 percent in 1998 to 2.3 percent in 2000. Growth through the next biennium is estimated at 0.4 percent annually. This factor impacts any consumption taxes and overall profitability.
- Since 1990, inflation has averaged 2.7 percent annually, and is estimated at 2.2 percent through the next biennium.
- Between 1990 and 1997, U.S. corporation tax profits increased an average 9.9 percent per year, but have decreased an average 2.7 percent annually from 1998 through 2001. In 2002 and 2003, corporate profitability increased by 7.1 percent and 15.4 percent respectively, and that trend is expected to continue, with projected annual increases of 13.5 percent, 34.8 percent, 1.5 percent, and 3.6 percent between 2004 and 2007.
- Property tax values increased slowly in the 1990s but fell in fiscal 2000 and 2001, primarily due to legislative tax changes. Property values resumed an upward trend in 2003, and that trend is expected to continue through the next biennium. However, net taxable value growth in tax year 2006 is expected to be near 10 percent as several tax increment financing districts are eliminated.
- Interest rates dramatically declined beginning in January 2001 to an unprecedented low in 2004. However, as the economy regains strength, interest rates are projected to increase through the 2007 biennium.
- As discussed in the previous section, high energy prices, especially for oil and natural gas production, are expected to substantially increase Montana production. Oil and gas production was 19 million barrels in 2003, and is expected to increase to 25 million barrels in 2005, 28 million barrels in 2006, and 30 million barrels in 2007. Natural gas production was 80 million MCF in 2003, and is expected to be 95.2 million MCF is 2005, 101 million MCF in 2006, and 106 million MCF in 2007.

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 0.4 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 average age, 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 retirement age.

The Martz budget, following a biennium that saw reductions in state services to balance the budget, reflects a steep demand for government services due to caseload and service user population increases. The executive requests a $210 million general fund increase over the FY 2004 base just to continue existing state services. The highest increases are in human services, education, and corrections, which represents nearly 87 percent of all general fund spending. In total, the executive budget requests a $312 million (11 percent) increase in general fund over the FY 2004 base.

GENERAL FUND ECONOMIC IMPLICATIONS – SUMMARY

In summary, revenue growth is expected to be moderate through the 2007 biennium, and when coupled with a large beginning general fund balance, the 2005 Legislature faces a nearly unprecedented surplus as it begins to prioritize state spending. Montana generally escaped the economic recession of the early 2000s, and although state revenues dropped off sharply, they are expected to slowly recover in the 2005 and 2007 biennia from the significant declines in the 2003 biennium.

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, especially in view of the recent court decision that schools are under-funded. Human services costs will continue to escalate because of greater caseload demands, higher medical costs, and a higher state Medicaid match rate to due improved per capita incomes. Corrections population growth projections also suggest significant expenditure growth pressures.

While the legislature faces a brighter picture than two years ago, caution is in order. Income tax growth will be moderate during the transition to SB 407 (tax reform), and the full effects of the SB 407 tax cuts will not be fully felt until fiscal 2008, when the increase in the capital gains credit to 2 percent becomes effective for a full fiscal year. The bonus depreciation provisions will not add to corporation tax liabilities past the 2007 biennium. Furthermore, there is always uncertainty surrounding the price of oil and a quieting of the war in Iraq could send oil prices down sharply, slowing new drilling activity. In addition, the long-term stability of the general fund is cloudy, as discussed beginning on page 142 of this volume.

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 2007 biennium budget, in view of the existing and forecasted economic conditions. We begin, however, with an explanation of how the state went from a record deficit in the last session to a record surplus in the 2007 biennium.

BUDGET SURPLUS: HOW WE GOT HERE

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 U.S. 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.

Beginning in fiscal 2004, Montana's revenue picture continued to show signs of weakness. Income tax receipts were sluggish, interest rates continued at historic low levels, and corporation income tax refunds were significant. In early calendar 2004, however, the first signs of an improving revenue picture started to appear. By early June 2004, after most individual and corporation income tax returns were processed, it was quite apparent that both of these key revenue sources were going to exceed legislative expectations. At this same time, oil and natural gas tax revenues were mushrooming and investment earnings were improving.

The three income sources primarily responsible for Montana's revenue picture reversal are individual income, corporation income, and oil and natural gas taxes. Individual income tax has experienced increased growth resulting in large part from the federal Jobs and Growth Tax Relief Reconciliation Act of 2003 (federal tax policy changes), an improvement in wage growth (especially in real wage growth per worker), and a higher capital gains base in calendar 2003. The corporation income tax has rebounded as Montana and multi-state corporations have recovered from the 2001 recession and the effects of "9/11". Additionally, the impact of the federal stimulus bonus depreciation provisions of calendar 2002 and 2003 will now create a decrease in the amount of depreciation expense corporations can claim in future years, which will result in increased tax liabilities. Finally, both oil and natural gas prices have increased dramatically in response to the war in Iraq and uncertainty about future supplies. As a result of the higher prices, new drilling activity for oil is up substantially. Production levels are once again increasing, reversing the production declines observed during the last ten years.

The following discussion provides the projected ending fund balance for the 2007 biennium.

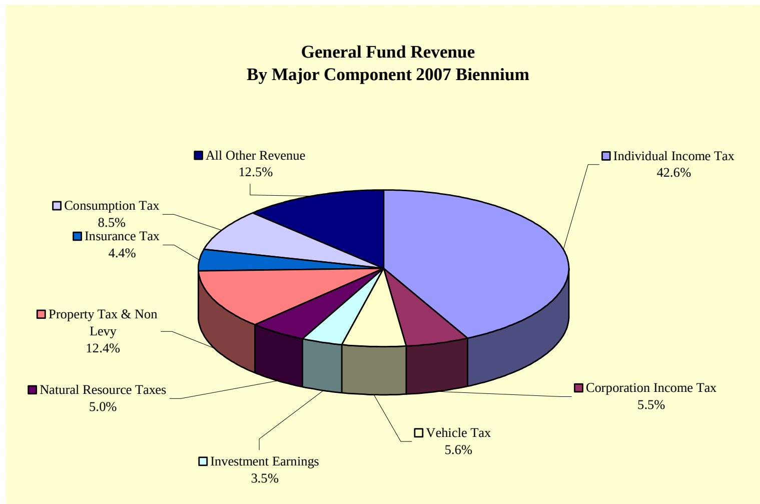
2007 BIENNIUM – PROJECTED GENERAL FUND BALANCE

The state general fund is the primary account that funds a significant portion of the general operations of state government and is often referred to as the state's checking account. This account has grown from slightly less than $700 million in FY 1990 to almost $1.3 billion in FY 2004, or approximately 5.0 percent annually. Figure 2 shows where the money in this account comes from by major revenue category (as estimated by the Revenue and Transportation Interim Committee for the 2007 biennium), while Figure 3 shows how the money is expended by major expenditure category (as requested in the Martz executive budget).

In the 2007 biennium, over 60 percent of total general fund revenues come from income and property taxes. Total revenues to the account for the 2007 biennium are projected to be nearly $2.9 billion, which is an increase of $132.1 million, or 4.8 percent from the 2005 biennium. Total general fund disbursements represent approximately 37 percent of all state expenditures in the general, state special, federal special, and selected proprietary fund types.

Figure 3 shows how the general revenues are expended by governmental function in the executive budget (present law only). As the figure shows, education consumes 48 percent, human services 21 percent, and corrections 8 percent of general fund revenues. It should be noted that statutory and transfer appropriation expenditures are shown separate from the agency responsible for the appropriation.

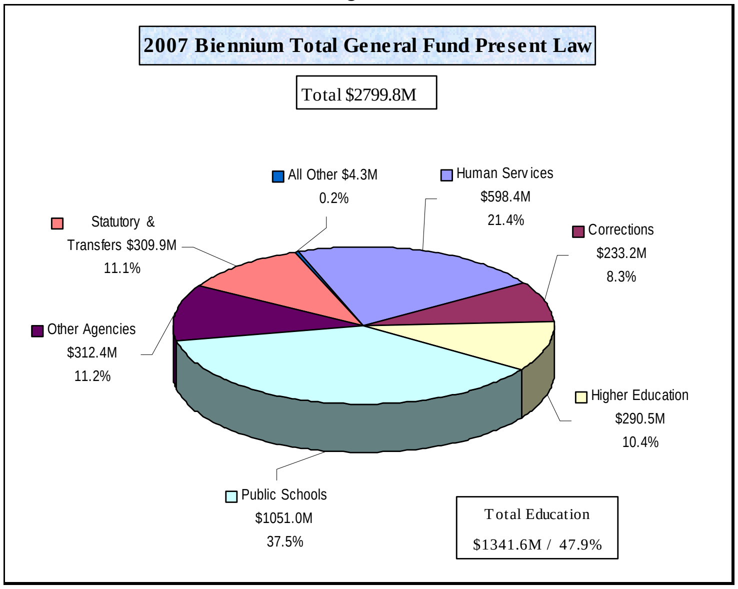
Figure 2



Major Category	2005 Biennium Estimate Millions	2007 Biennium Estimate Millions	Percent Change
Individual Income Tax	$1,193.986	$1,234.869	3.42%
Corporation Income Tax	134.055	158.548	18.27%
Vehicle Tax	163.967	162.190	-1.08%
Investment Earnings	87.901	100.336	14.15%
Natural Resource Taxes	124.993	145.916	16.74%
Property Tax & Non Levy	339.582	358.486	5.57%
Insurance Tax	115.805	127.383	10.00%
Consumption Tax	240.558	247.732	2.98%
All Other Revenue	365.357	362.856	-0.68%
Total General Fund	**$2,766.204**	**$2,898.316**	**4.78%**

Balancing general fund appropriations against anticipated revenues is a major challenge of each legislative session and requires a significant coordination between the taxation and appropriation committees. Based on revenue estimates adopted by the Revenue and Transportation Interim Committee (RTIC) on November 16, 2004, there are sufficient revenues to support the executive present law budget recommendations, leaving a ending fund balance of a positive $293.3 million (Figure 4). Because of this high balance, there are sufficient revenues to accommodate all of the executive new proposals, including the executive's recommended ending fund reserve of $162.9 million.

Figure 3



If the total executive budget were funded as requested, the ending balance in the general fund would be $181.3 million (Figure 4). One of the reasons for this higher projected balance than the executive is that the projected balance uses the final revenue estimate recommendations of the RTIC. The executive budget was based on lower revenue estimates developed by the executive's staff. The result is that the balanced budget as submitted by the executive exceeds the executive recommended $162.9 million reserve when using RTIC general fund revenue estimates.

A projected general fund balance of nearly $300 million after funding the executive present law budget leaves the legislature with a sizeable surplus to apply toward:

- An appropriate ending fund balance reserve (the executive recommends $80 million, and national experts recommend a minimum 3 percent -- $87 million)
- Consideration of $112.0 million in executive new initiatives
- Other legislative priorities and initiatives

2007 Biennium General Fund Balance
Based on Present Law (In Millions)

	Actual Fiscal 2004	Estimated Fiscal 2005	Estimated Fiscal 2006	Estimated Fiscal 2007	Estimated 2005 Biennium	Estimated 2007 Biennium
Beginning Fund Balance	**$43.065**	**$132.873**	**$194.725**	**$227.012**	**$43.065**	**$194.725**
Revenues						
Current Law Revenue	1,381.565	1,384.639	1,429.143	1,469.173	2,766.204	2,898.316
Total Funds Available	**$1,424.630**	**$1,517.512**	**$1,623.868**	**$1,696.185**	**$2,809.269**	**$3,093.041**
Disbursements						
General Appropriations	1,161.831	1,167.626	1,243.157	1,242.405	2,329.457	2,485.562
Statutory Appropriations	126.600	128.660	133.085	135.606	255.260	268.691
Local Assistance Appropriations						
Miscellaneous Appropriations	1.866	2.385			4.251	
Non-Budgeted Transfers	10.052	17.469	20.917	20.314	27.521	41.231
Supplemental Appropriations		12.651			12.651	
Language Appropriations	1.372	0.350			1.722	
Feed Bill Appropriations		7.000	2.100	8.050	7.000	10.150
Anticipated Reversions	(19.683)	(8.979)	(2.403)	(3.452)	(28.662)	(5.855)
Total Disbursements	**$1,282.038**	**$1,327.162**	**$1,396.856**	**$1,402.923**	**$2,609.200**	**$2,799.779**
Adjustments	(9.719)	4.375			(5.344)	
Unreserved Ending Fund Balance	**$132.873**	**$194.725**	**$227.012**	**$293.262**	**$194.725**	**$293.262**
Net Operations	**$99.527**	**$57.477**	**$32.287**	**$66.250**	**$157.004**	**$98.537**
New Executive Proposals Not Included Above						
Revenue Inititative			**$2.932**	**$3.342**		**$6.274**
Disbursement New Proposals						
Long Range Building			10.000	20.000		30.000
Cultural Trust Repayment			3.913			3.913
Protested Property Tax Reserve			4.000			4.000
Retirement System Funding			3.600	3.600		7.200
Executive Pay Proposal			9.508	22.036		31.544
Language Appropriations			0.887	0.705		1.592
HB2 New Proposals			24.076	15.960		40.036
Total Disbursement Inititative			**$55.984**	**$62.301**		**$118.285**
Potential Ending Fund Balance Without Reserves			**$173.960**	**$181.251**	**$194.725**	**$181.251**

Figure 4

While this is an enviable position to be in, especially compared to the deficit situation just two years ago, there are a number of spending pressures to be addressed, including the K-12 court decision that schools are under-funded (not addressed in the executive budget), and employee union demands for employee pay and benefit increases. In addition, much of the surplus ($293.3 million) would have to be used for one-time initiatives as opposed to expanding ongoing services, if a structural balance in the general fund is to be maintained (see the discussion of "Structural Balance" on page 108). Thus, while the outlook is clearly optimistic, the 2005 Legislature still faces a number of fiscal challenges. These challenges are discussed in the next section.

A more detailed discussion of the general fund projection begins on page 43 of this volume.

What are the major fiscal challenges facing the 2005 Legislature?
What are the Executive solutions?
What are the significant issues identified by the LFD analysis?

MAJOR FISCAL CHALLENGES / SOLUTIONS / ISSUES

Following a biennium in which significant service reductions were taken, some major revenue sources have taken a surprising turn. Bolstered by greater than expected individual income tax collections and higher oil prices, state revenues have increased significantly, leaving a sizable projected surplus as of the end of FY 2005. However, much of the surplus is categorized as "one-time" moneys, which implies limits on how such money should be spent. In addition, there is still strong pressure for increased funding for assorted state services.

The upcoming legislature will continue to face many fiscal 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 the legislature will have to consider in formulating the 2007 biennium spending plan and related fiscal policy. Below each is a summary of the executive proposed solution and issues raised by the LFD analysis where appropriate.

Fiscal Challenge

Funding for schools is arguably the number one fiscal challenge in view of a district court decision in April of 2004 (upheld by the Montana Supreme Court in November 2004) finding that state funding for K-12 education is not adequate and that the current funding methodology is unconstitutional. The state is directed by the court to find a solution by October 2005. The magnitude of the K-12 education budget, the complexities of determining a solution, and the limited time frame for finding a solution will make this issue difficult to resolve.

Executive Proposal: The executive budget does not address the court decision that current funding is inadequate. The Governor's request for schools provides primarily a present law increase and other inflationary items. Inflation has been applied to basic and per ANB entitlements as required by statute, and to the state contribution to special education. Other expenditure categories such as facility bond payments, block grants, and transportation received increases. Increases in funding are offset somewhat by expected enrollment reductions. The Governor's proposal includes $28 million general fund for increases to local education activities.

Issue: Since funding to satisfy the court ruling on inadequate education funding is not included in the executive budget, the legislature will likely have to provide additional funding above the proposed budget to meet this need. Funding cannot be determined until the legislature defines "quality" education and develops a funding methodology based on educationally relevant factors (needs assessment). Since the amount of additional funding required could be substantial, this is a potential "budget buster".

Fiscal Challenge

Health care cost inflation and caseload increases continue to be major contributors to greater than average growth in health care services budgets. With medical cost growth well ahead of normal inflation and prescription drug increases in double digits, there is no relief in sight. This trend follows recent years of budget reduction caused by revenue shortfalls. Add to that the growing caseloads needing services, fueled to some degree by an aging population, growing demands for increases in funding, and reductions in the federal Medicaid rate. Underestimating costs could result in a budget-breaking supplemental request or further reductions in health care services.

Executive Proposal: The executive budget maintains current services levels, while providing increases of $83 million general fund, $36.8 million state special revenue, and $214.4 million federal funds. Of the general fund increase, $32 million funds service and caseload increases and $55 million addresses the changes in the federal match rate.

Issue: All state governments, and Montana is no exception, deal with the impact of rising medical costs. Nationally, it is estimated that 10 percent of state expenditures are for medical costs, which include payments for state employee health benefits, Medicaid services, state Children's Health Insurance Programs (CHIP), and medical services provided and paid for by state institutions. The legislature may wish to study whether there is a way for state funded health services to either be combined or to learn from each plan's cost control methods for Montana to realize savings.

Fiscal Challenge

Correctional offender population continues to grow. From FY 1997 through FY 2004, the number of offenders in both secure custody and community supervision increased from 7,453 to 10,353, a growth of 3.9 percent. The average daily population for FY 2004 is estimated to have a 4.5 percent increase over FY 2003. Controlling expenditures in this area of the budget can go way beyond simply funding incarceration or supervision programs. It requires legislators to look at sentencing criteria, alternative correction programs, ways to rehabilitate offenders more quickly, and ways to keep people out of the criminal justice system.

Executive Proposal: General fund expenditures for the 2007 biennium increase $24.1 million or 11.5 percent, when compared to the 2005 biennium. In addition to statewide present law adjustments, increases anticipate more than a 4 percent growth in population each year, and include additional probation and parole officers and an increase in private contract beds, both intended to deal with the growing population.

Issue: All of the secure facilities, with the exception of the private prison in Shelby, will be well above their rated capacities or at or above their operational capacities during some point in the 2007 biennium. The Shelby facility would be expanded to meet future growth.

Fiscal Challenge

Higher education has been funded to a greater and greater degree in recent biennia with increased tuition charges to students, 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.

Executive Proposal: The Governor's proposal includes funding for the resident student share of present law adjustments with general fund, with the intent of minimizing tuition increases. According to the executive budget, if the Board of Regents adopts the Governor's statewide adjustment proposals and the 3 percent pay plan proposal, the required tuition increase should only be 2 percent per year. This compares to a system-wide average of 11 percent for the 2005 biennium.

Issue: Board of Regents projections do not appear to agree with those of the executive. The board projects tuition increases ranging from 4.3 to 11.7 percent, depending on the state level of funding in HB 2, the state share calculation that is used in HB 13 (pay plan), and the actual level of funding the Board of Regents allocates to specific university level new initiatives.

Fiscal Challenge

State employee pay and benefits are likely to be a hot topic for the 2005 session. State employees received no salary increase in FY 2004 and a 25-cent per hour increase in FY 2005, which was delayed to take effect mid-year. However, the state contribution to employee health insurance benefits attempted to keep pace with the growth in those costs, costs that continue to climb. With the revenue picture improved, state employee union representatives will likely seek some redress of employee compensation issues.

Executive Proposal: The executive pay plan proposal provides for a 3 percent increase October 1 each year of the biennium, plus increases in the state contribution to health insurance of $46 per month for FY 2006 and an additional $51 per month in FY 2007. The increases in the state contribution for insurance take effect on July 1 of each year for university system employees and January 1 for all other state employees.

Issue: As of this printing, there is no negotiated agreement between the executive and employee groups. Therefore, it is not known what the employee representatives' position is in regard to pay and benefits demands, and the executive proposal.

Fiscal Challenge

Public employee retirement funds have suffered from lower interest rates and equity market losses. Reduced investment earnings have resulted in actuarial estimates of unfunded liabilities that exceed acceptable levels.

Executive Proposal: The Martz budget proposes: 1) to temporarily increase the employer contributions to the plans and 2) various plan changes that would impact benefit calculations for future employees (members). The proposed budget provides $7.2 million for increased employer contributions. Legislation is proposed to effect benefit changes for future public employees, although current versions of the legislation differ from the assumptions contained in the executive budget.

Issue: The temporary employer contribution increases are expected to address the current unfunded liabilities, but what impacts will member demographics have on future unfunded liabilities? Additionally, even though an unfunded liability exists, there is the potential to erase the liability with stronger investment return. The state has no legal obligation to address the unfunded liability in this session, and the question is more of an assessment of responsible fiscal management.

Fiscal Challenge

Management of capital assets is an important function of state government. A key component is the maintenance of state facilities and other assets. The deferral of such maintenance has been a long-standing issue, made worse by the budget shortfalls of recent years. Delaying maintenance activities can result in higher future costs as facilities deteriorate beyond the need for ordinary repairs and replacements.

Executive Proposal: The highest priorities in the cash portion of long-range building proposals are for repair and maintenance activities. The executive proposes a one-time expenditure of $30 million from the general fund to "reduce the growing statewide backlog of safety, major repairs, and deferred maintenance projects". This is in addition to a projected cash balance of $5.1 million in the long-range building fund, for a total amount of $35.1 million.

Issue: There is not a clear picture of what the total deferred maintenance exposure currently is, although it is roughly estimated to exceed $100 million. The legislature may want to request a more accurate estimate, a long-range plan for addressing deferred maintenance, and an assessment of the risks associated with deferred maintenance.

Fiscal Challenge

Public defender services were the topic of a subcommittee of the legislative Law and Justice Interim Committee during the 2003-2004 interim. Partially in response to a pending lawsuit (on hold until May 2005), the subcommittee drafted legislation to create a statewide public defender system to address issues raised by the American Civil Liberties Union (ACLU) in its lawsuit. The ACLU alleges that public defender services are not provided throughout the state in an equitable manner and that it is a conflict of interest when a judge appoints a public defender in a case that will be heard by that judge.

Executive Proposal: The executive budget does not address the potential statewide public defender system. It will be presented in legislation (LC 0214) crafted by the interim committee.

Issue: The current estimate of the additional ongoing cost of the statewide public defender system is $6.0 million ($3.5 million for the transitional 2007 biennium). These costs include payments for public defender services provided by seven county-managed public defender offices throughout the state, services provided by private attorneys, transcripts, private investigator services, and witness fees and expenses.

Fiscal Challenge

Pending litigation and subsequent court rulings can impact state finances. Currently, there is one legal action pending that seeks changes and increased funding for services for the developmentally disabled: the Montana Association for Independent Disability Services, Inc. (MAIDS) lawsuit. Another lawsuit pending at this time relates to compensation issues for highway patrol officers and could result in an award of back pay. In addition, during FY 2004, two decisions were rendered that are expected to have potential fiscal impact in the upcoming biennium: 1) the Montana Advocacy Program (MAP) Travis D. class action lawsuit; and 2) the lawsuit which challenged the adequacy of state funding for schools (discussed on page 119 under "K-12 Lawsuit Issue").

Executive Proposal: The executive budget for the Department of Public Health and Human Services includes elements of the Travis D settlement agreement.

Issue: The settlement agreement in the Travis D. litigation requires that the Department of Public Health and Human Services take several actions, including proposals for some statutory changes during both the 2005 and 2007 legislative sessions, movement of 45 individuals from the Montana Developmental Center to community settings, and a number of other items, some of which have budgetary impacts. The potential liability in the other pending litigation is unknown, but could be substantial. The legislature should be aware of this liability as it crafts the 2007 biennium budget.

Fiscal Challenge

Supplemental emergency appropriations for the next biennium are not budgeted 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, although for FY 2005, no fire costs supplemental is expected. Fire costs for FY 2005 were funded by a one-time federal grant. For any future biennium, the legislature needs to keep in mind that supplemental appropriation requests are common, with general fund supplemental appropriations averaging $29 million per biennium over the past 10 biennia.

Executive Proposal: The executive budget includes general fund supplemental appropriation requests totaling $12.7 million for FY 2005 (see page 77). Supplemental appropriations for the 2007 biennium will be addressed in HB 3 of the 2007 session.

Issue: Neither the executive nor the legislature includes projections for supplemental appropriations in the 2007 biennium. Typically, the potential for supplemental appropriations is considered a component of the fund balance reserve. This speaks to the need for an adequate reserve, which is discussed later.

Fiscal Challenge

State assumption of district courts has been a difficult issue for the Judiciary since its implementation through SB 176 in the 2001 session. Although questions of who pays for what costs have been answered, there are still concerns that the program is under-funded. A sizable supplemental of $5.8 million is requested for FY 2005 and this is also reflected in the Judiciary's request for the next biennium.

Executive Proposal: The executive budget includes a Judiciary budget that is $7.8 million less than the Judiciary submission. According to 17-7-122, MCA, the Judicial Branch budget proposal is included in the executive budget proposal, but the executive does not have to include expenditures above the current base as part of the balanced budget. The executive does, however, list the decision packages that are not included in the Martz budget.

Issue: Since the implementation of SB 176 in 2001, the Judicial Branch has indicated that its budget to pay for the district court assumption was not adequately funded. The budget for the district court assumption is split into fixed and variable costs. The fixed costs primarily are comprised of employee payroll costs while variable costs are primarily for public defender services. One difficulty has been that the Judiciary does not budget and account for variable costs in a way that clearly reports those costs or offers an opportunity to control those costs. Before the variable costs can be fully addressed in the budget, there needs to be better accountability for those costs.

Fiscal Challenge Potential **loss of federal funds** as a source of funding for many state and federal programs is a concern because of the large federal deficit and the administration's goal of cutting the deficit in half by 2008. The loss of federal funds translates to either reductions in services to citizens or increased state costs to offset the loss, loss of jobs in the state, and loss of "imported" money into the Montana economy.

Executive Proposal: The executive budget includes $3.2 billion in federal funds for the 2007 biennium, a $311.8 million, 10.8 percent increase over the 2005 biennium.

Issue: The Montana budget has an increasing reliance on federal funds, as federal funds comprise 46.7 percent of the total proposed HB 2 budget. A significant federal cutback could have a devastating impact on government services in Montana and/or the state budget.

Fiscal Challenge **Long-term stability of the general fund** becomes an issue when changing demographics become a big player in the demand for government services or are an influencing factor in the generation of state revenue. Emerging examples of potential instability are: 1) the aging population of Montana as well as other states; 2) dependence on revenue from the cigarette tax that is partly intended to discourage the use of tobacco products that generate the tax revenue; 3) the education funding lawsuit liability; and 4) the federal funds reliance issue discussed above.

Executive Proposal: The executive budget does not address this issue.

Issue: The legislature needs to be cognizant of the long-term outlook for the general fund if a future budget crisis is to be avoided. The legislature may wish to consider an interim study of the long term stability of the general fund.

Fiscal Challenge **Economic development** has been a high priority for the Martz administration. Governor-elect Schweitzer campaigned strongly on economic development initiatives. What investment will be necessary to continue current efforts and/or fund new initiatives?

Executive Proposal: The most significant new initiative that relates to economic development is the "Shared Leadership for a Stronger Montana Economy" project of the Montana University System. The executive budget includes $9.9 million of general fund moneys for several new proposals related to this project.

Issue: As is true for many economic development efforts, there needs to be accountability for the investment that is committed to the project. Measurable goals and objectives, and related accountability measures, are critical in determining the effectiveness of these efforts.

Fiscal Challenge

Controlled budget growth (structural balance) will continue to be a concern, regardless of the sizable projected fund balance expected for the end of the 2005 biennium. A large portion of the available general fund revenues is from a one-time source. Temptations to use "one-time" revenue for "ongoing" programs and services will persist.

Executive Proposal: The executive budget is structurally balanced. This is demonstrated by the difference between the projected revenue and the ongoing expenditures. For FY 2006, revenue is projected at $1,411.7 million and ongoing expenditures at $1,386.6 million. For FY 2007, revenue is projected at $1,455.9 million and ongoing expenditures at $1,430.7 million. In each case, revenues exceed ongoing expenditures by about $25 million.

Issue: While the executive uses an "ongoing" expenditure amount in its calculation of structural balance, it uses all projected revenues. One might argue that a portion of the projected revenues should not be included as "ongoing". For example, the current level of oil and gas revenues might not be maintained, since oil prices have already began to drop. This is a lesson that almost all states should have learned about the growth experienced in mid to late 90's, and leading up to the 2001 recession. For most states, revenue growth slowed significantly with the recession, stranding inflated expenditure levels without an adequate funding stream. Severe expenditure reductions and depleted "rainy day funds" were the norm for a few years following.

Fiscal Challenge

Adequacy of the ending fund balance reserve will need to be monitored by the legislature as the session progresses. What will it take to ensure that Montana keeps an adequate "safety net" in place?

Executive Proposal: The executive budget includes a $162.9 million projected fund balance at the end of the 2007 biennium, but recommends that the legislature leave at least an $80 million ending fund balance when a final budget is passed.

Issue: While this is well above the recommended minimum fund balance, other spending demands will likely compete for a share of this balance. National experts consider a 3 percent reserve to be a minimum ($87 million). The legislature should be looking at retaining at least a $75 million dollar reserve as a safety net. Montana is one of only three states without a rainy day fund and may also want to consider setting up and placing seed money in a "rainy day fund", as is being proposed by more than one legislative bill this session.

Fiscal Challenge

Economic uncertainties can undermine revenue-forecasting efforts, and contribute to an increased demand for government services in areas such as human services and corrections. As in any legislative session, there are many unknowns surrounding revenue forecasts. Oil and gas prices appear to be declining, interest rates are slowly increasing, and there is more talk at the federal level of income tax reform. Assumptions used in the revenue forecasting process are based upon the best information available, but what might happen to change those assumptions?

Executive Proposal: The executive budget is based on revenue estimates that are $14.0 million below those adopted by the Revenue and Transportation Interim Committee.

Issue: The current national economic picture is volatile at best, and with the inherent increase in government service demands and eligibility, are revenue estimates conservative enough, and can budgets be contained without cost over-runs?

Fiscal Challenge

General fund spending without HB 2 appropriations occurs in general fund non-budget transfers and through statutory appropriations. Authority for such spending is authorized in statute, but doesn't receive the usual scrutiny that HB 2 appropriations require. The challenge in this case is for the legislature to minimize the occurrence of spending that does not require regular scrutiny by the legislature.

Executive Proposal: The executive budget does not address this issue.

Issue: The legislature has established numerous statutory appropriations and transfers in statute, expenditures that do not receive the same scrutiny or prioritization as HB 2 appropriations. Statutory appropriations for the 2007 biennium are estimated to be $269 million general fund and transfers are estimated to be $41 million.

EXECUTIVE 2007 BIENNIUM BUDGET HIGHLIGHTS

INTRODUCTION

As discussed in the preceding sections, the revenue picture is much improved since the 2003 session, but there are many challenges facing the 59th Legislature. As with every session, legislators will consider hundreds of bills, many of which will generate revenues or result in additional state spending. From a fiscal perspective, the most important of these bills is the general appropriations act (HB 2). The executive budget proposal is represented in HB 2, as well as other legislation and existing law. What are the key features of the executive budget?

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 Proposals-Summary" section on page 59 and expenditure proposals are summarized in the "Executive Expenditure Proposals-Summary" section on page 61. Volumes 3 and 4 of this publication contain the detailed discussion of each agency. Following are highlights of key issues of the budget.

TOTAL BUDGET SUMMARY

The executive budget proposal for HB 2, the general appropriations act, totals $6.9 billion for all funds, of which $2.5 billion is general fund. The executive includes total spending increases for the 2007 biennium (as compared to the 2005 biennium) of $227.9 million general fund and $654.6 million total funds. This represents biennial increases of 9.9 percent general fund and 10.6 percent total funds. General fund is distributed as follows:

- 54 percent goes to education (K-12 and higher education) - $1,358 million
- 24 percent goes to human services - $604 million
- 9 percent goes to corrections - $235 million
- 13 percent goes to all other government (over 20 agencies) - $330 million

Outside of HB 2 appropriations, the executive spending plan includes other legislatively authorized general fund expenditures:

- Statutory appropriations - $269 million, including $170 million for distribution to local government
- Non-Budgeted Transfers - $41 million

HIGHLIGHTS OF REVENUE PROPOSALS

The executive budget proposal does not propose any major tax policy initiatives. There are, however, two minor revenue initiatives that would increase general fund revenues in the 2007 biennium.

- Paying-off the Department of Revenue Computer System loan of $16 million has an offsetting impact on revenues because it would eliminate a need to assess a fee of general fund revenues authorized by the 2003 Legislature, increasing general fund revenues by $6 million in the 2007 biennium.
- A request for an additional pathologist position for the Department of Justice forensic lab would result in additional general fund revenue of $0.3 million in the 2007 biennium, by billing the counties for which the services are provided.

HIGHLIGHTS OF EXPENDITURE PROPOSALS

The 2007 biennium executive expenditure proposals for HB 2 include recommendations for an additional:

- $228 million general fund, a 9.9 percent increase
- $115 million state special revenue, an 11.6 percent increase
- $312 million federal funds, a 10.8 percent increase

The following summarizes the majority of the executive spending plan.

- General fund increases are dominated by increases for the highest cost policy areas: human services, K-12 education, higher education, and corrections. There are also significant increases for the Judiciary and the Department of Revenue. Increases for these program areas are summarized below.
- Present law changes are dominated by four factors:
  - Payout of debt and settlement obligations
  - Increasing caseloads in various human service programs
  - Increases for statewide present law adjustments (including full funding of personal services less vacancy savings, fixed costs, and inflation)
  - Reductions that continue some of the FTE reductions taken in the last session.
- General fund new proposals are dominated by computer system completion, development, or enhancement in several agencies; the “shared leadership” project and new equipment in higher education; various program enhancements in human services; and increases for various K-12 allocations to schools.
- FTE increase by a net of 106.09 FTE in FY 2006 and 91.16 FTE in FY 2007.

Major Program Areas

Human Services

Human services would receive a 16 percent general fund increase over the 2005 biennium, reflecting caseload increases and various service enhancements. A higher required state match rate for Medicaid services that increases general fund reduces federal funds by a like amount.

K-12 Education

The executive budget seeks a $28 million, or 2.7 percent, general fund increase for elementary and secondary education, primarily due to statutory inflationary adjustments. An increase of $19 million in other funds is almost entirely due to additional federal grants.

Higher Education

Higher education receives a $22.4 million, or 8.1 percent increase, in general fund and a $6.9 million in other funds – the executive proposal addresses an increased state general fund share to keep tuition increases down, its "shared leadership" economic development initiative, and new equipment for the two year schools, as primary drivers of this increase.

Corrections

Corrections receives a $24.1 million, 11.5 percent general fund increase, largely for population increases in both secure care and community corrections, and to manufacture the new issue license plate.

Judicial Branch

The Judiciary, under the executive proposal, receives a $12.2 million, 20.8 percent general fund increase over the 2005 biennium, due primarily to higher district court costs.

Revenue

The Department of Revenue seeks a $33.9 million, 60 percent general fund increase in spending, primarily for computer system projects – $16 million of which is to pay off the financing of the initial phase of the IRIS project (POINTS replacement).

Vacancy Savings

The executive applied a 4 percent per year vacancy savings factor that reduces agency budgets by $49 million total funds, including approximately $19.1 million general fund.

Major Changes in Executive Proposals

Figure 5 lists the major individual components of the general fund increase included in the executive budget. The amounts shown are based upon a comparison of the 2007 biennium budget with the FY 2004 base (multiplied by 2 for the comparison). The comparison is shown this way because the budget for both years of the 2007 biennium is built from the FY 2004 base.

Figure 5

Major Factors - General Fund Increase
From the Doubled FY 2004 Base
2007 Executive Budget

Element	--- General Fund --- Funds (in millions)	Percent of Total	Cumulative Percent
Doubled 2004 Base	$ 2,275.6	---	---
Major Adjustments - $250.0 million			
Medicaid Matching Rate*	$ 55.0	22.0%	22.0%
Human Services Caseloads and Service Changes	38.3	15.3%	37.3%
Corrections Populations and Overtime	24.0	9.6%	46.9%
Payment of all IRIS Computer System Debt/Crow Tribe Settlement	23.0	9.2%	56.1%
MUS Enrollment/K-12 Enrollment/Inflation	19.4	7.8%	63.9%
Statewide Present Law Adjustments	15.4	6.2%	70.0%
Computer Systems Update/Completion/Replacement	13.5	5.4%	75.5%
MUS Shared Leadership/Equipment	9.9	4.0%	79.4%
DPHHS Institutional Costs (overtime, utilities, etc.)	6.6	2.6%	82.1%
License Plate Manufacture/Replacement**	4.5	1.8%	83.9%
Emergency Telecommunications	4.1	1.6%	85.5%
All Other Agencies	36.2	14.5%	100.0%
Total 2007 Biennium	$ 2,525.6	100.0%	

*Includes $1.1 million for non-Medicaid expenditures that use the Medicaid matching rate.
**Includes expenditures in corrections and the Department of Justice

Other Features of the Executive Budget (not in HB 2)

Statutory Appropriations

Statutory appropriations and local assistance have a total estimated cost of $269 million, of which $170 million is for distribution to locals - these local government entitlements increase by $5.5 million for inflation.

Executive Pay Plan

The employee pay plan (HB 13) provides a 3 percent salary increase on October 1 of each year and an increase in the state's share of the employee health insurance, at a total cost of $58 million, with about $31 million being general fund.

Supplementals

Supplemental appropriation requests for FY 2005 (HB 3) total $12.7 million general fund – the largest being for the Judicial Branch, the Department of Corrections, and the Department of Public Health and Human Services.

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.

- **K-12 Lawsuit Issue.** The district court decision found the state's share of school district spending inadequate, and found that Montana's funding formula is not reasonably related to the costs of providing a basic system of free quality public elementary and secondary schools. The Montana Supreme Court subsequently upheld the decision. The conclusion of the District Court and the Supreme Court is that until such time as the legislature assesses education needs and defines "quality", it is not in a position to construct a funding system rationally related to educationally relevant factors. The state is directed by the court to find a solution by October 2005. (Page 119)

- **Other Litigation Issues.**
    - o *Human Services*. In September 2002, the Montana Association for Independent Disability Services, Inc. and several individuals with developmental disabilities filed suit that several statutory and constitutional provisions have been violated. A finding in favor of the plaintiffs and requiring the state to reimburse contractors at a level that provides direct care wage rates that are comparable to state employees would likely have a financial impact on the developmental disabilities system that would be measured in terms of millions of dollars. Another lawsuit, the Travis D. litigation, was a class action lawsuit on behalf of individuals with developmental disabilities for which a court ordered settlement agreement of this litigation was signed. (Page 124)
    - o *Highway Patrol Class Action Lawsuit*. This is a class action lawsuit that includes 323 officers seeking overtime compensation for all lunch hours for a period of 3½ years and to have overtime and retirement contributions and benefits recalculated based on the contention that subsistence pay should have been included in the officers' base pay. A settlement agreement has been signed by the parties to the lawsuits that indicates a settlement amount of $8.5 million. (Page 124)
    - o *PPL Protested Taxes*. Protested taxes are currently deposited into the general fund for support of government services. Because of the uncertainty of these moneys, the executive is proposing in legislation to transfer half of the protested taxes to a state special revenue account to be available for potential refunds. The legislature is being asked to determine an approach that is prudent for the state. (Page 125)

- **Tobacco Settlement Funds.** Montana receives revenue as a settling party to a Master Settlement Agreement. Of $42 million expected in the 2007 biennium, 40 percent is earmarked for the Tobacco Trust, 32 percent funds tobacco prevention programs (the executive is proposing to divert a portion of this allocation to other uses), 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 $7.9 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 126)

- **I-149: Cigarette and Tobacco Tax Increases.** Montana voters approved Initiative 149 in November 2004, increasing the tax on cigarettes and other tobacco products. The annual increase in revenues would be nearly $40 million. The initiative also changed the distribution of the tax revenue, by reducing the general fund share and the long-range building program share, maintaining the veterans home share, and creating a new account for health and Medicaid initiatives. In effect, however, the dollar share for the general fund is nearly the same, while the other areas see increases. The health and Medicaid initiative account receives most of the total increase. (Page129)

- **Jobs and Growth.** In response to severe fiscal shortfalls experienced by almost all states in FY 2002 and FY 2003, Congress passed legislation providing fiscal relief to states. Called the Jobs and Growth Tax Relief Reconciliation Act of 2003, the legislation consisted of two types of fiscal relief: 1) a temporary increase in the federal Medicaid benefits participation rate; and 2) a grant of $50 million. (Page 134)

- **Public Defender Study.** The Law and Justice Interim Committee is proposing legislation to establish a statewide public defender system. A related lawsuit, filed by the American Civil Liberties Union, is on hold pending the outcome of legislation. The current estimate of additional costs for the statewide system is $3.5 million for the 2007 biennium ($6.0 million ongoing). (Page 137)

- **District Court Assumption.** The Supreme Court's assumption of the district courts has presented some challenges, including significant cost over-runs, resulting in a supplemental funding request for FY 2005. This supplemental is mostly due to expenditures for public defender services provided by appointed, contracted or county-managed public defenders. (Page 139)

- **Medicare Modernization Act.** The federal Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (MMA) was signed into law in December 2003. The most significant change due to passage of the MMA is the addition of an outpatient prescription drug benefit (Part D) for Medicare beneficiaries. Despite state and federal implementation issues, outpatient drug assistance is a significant benefit for Medicare beneficiaries. To date, there are many undefined aspects of the MMA, including the underlying data needed to calculate the fiscal effects. (Page 140)

- **Long-term Stability of the General Fund.** 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. There are three key issues relevant to the ensuing legislative session and the necessary planning for subsequent sessions. They are 1) revenue stability, 2) reliance on federal funds, and 3) funding demands. (Page 142)

- **Statutory Appropriations.** Expenditures from statutory appropriations in the 2007 biennium are estimated at $269 million. Entitlement payments to local governments account for $170 million. These appropriations become a greater concern, as the legislature does not automatically review the amount of money appropriated in the same manner as appropriations in HB 2. (Page 148)

- **General Fund Transfers.** Transfers, estimated to be $41.2 million from the general fund to other funds in the 2007 biennium, continue to be at relatively high levels, primarily because of the impacts of HB 124 (2001 session), which reallocated revenue to the state that had formerly gone to local jurisdictions. 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 151)

- **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. The executive budget contains a projected ending fund balance in excess of $160 million, but recommends an $80 million balance. (Page 154). The LFA suggestion is a minimum $87.0 million reserve.

- **Other Major Funds.**
    - *Highway Special Revenue Account*. The 2005 legislature is faced with a declining working capital balance in the highways state special revenue account. The account is projected to end FY 2007 with a working capital balance of $19.1 million, which is down from a $39.1 million balance at the end of FY 2004. Projections indicate that expenditures will exceed revenues by $19.0 million in the 2007 biennium, with the imbalance continuing in future biennia. (Page 156)

    - *Resource Indemnity Trust*. The projected ending fund balance (June 30, 2005) of the Resource Indemnity Trust (RIT) exceeds the $100 million threshold. Therefore, the excess, estimated at $252,844, is available for appropriation. In addition, of seven accounts that have historically received allocations of Resource Indemnity and Ground Water Assessment Taxes or Resource Indemnity Trust interest earnings, two are projected to have negative balances by the end of the 2007 biennium. The legislature will need to address the distributions of RIT funding streams to insure a balance between revenues and disbursements. (Page 157)