# GENERAL FUND / FEDERAL FUNDS UPDATE 2005 BIENNIUM PROJECTED

A Report Prepared for the

## Legislative Finance Committee

By

**Terry W. Johnson**
**Principal Fiscal Analyst**
**And Staff**

December 5, 2003

Legislative Fiscal Division

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

# INTRODUCTION

The purpose of this report is to provide the committee with information on significant general fund revenue trends that are occurring in fiscal 2004 and to provide an outlook for the remainder of the 2005 biennium. The 2005 biennium outlook shows the projected ending fund balance when the federal Jobs and Growth Tax Relief Reconciliation Act monies are included.

At the committee meeting in October, our office expressed concerns over some of the revenue trends that were developing based on data through the end of September 2003. This report is based on information received through the end of November 2003.

The report is organized in three relevant sections. The first section discusses the 2005 biennium general fund outlook including a detailed discussion of the major general fund revenue sources. Significant disbursement issues impacting the 2005 biennium are also discussed. Section 2 addresses the potential for statutorily required reductions in spending per Title 17-7-140, MCA. Section 3 provides a brief outlook for the 2007 biennium based on information received so far this biennium.

# 2005 BIENNIUM GENERAL FUND OUTLOOK

## FISCAL 2004 REVENUE TRENDS

Based on information recorded through the end of November 2003 on the Statewide Accounting, Budgeting, and Human Resource System (SABHRS), total general fund receipts for fiscal 2004 were $362.4 million as shown in Table 1. This compares to $335.5 million collected for the same period of fiscal 2003. Total general fund collections are $26.9 million above last year's amount, which represents an 8.0 percent increase.

**Table 1**
**General Fund Receipts By Revenue Category For Fiscal 2004**

| Revenue Category | Estimated 2004 Receipts * | Through 11/30/02 Receipts | Through 11/30/03 Receipts | Over(Under) Change | Percent Change | HJR2 Est. % Change |
|---|---|---|---|---|---|---|
| GF0100 Drivers License Fee | $2,850,000 | $642,699 | $783,571 | $140,873 | 21.92% | 34.47% |
| GF0200 Insurance Tax | 56,038,000 | 10,550,305 | 10,789,821 | 239,516 | 2.27% | 10.29% |
| GF0300 Investment Licenses | 4,618,000 | 656,726 | 652,434 | (4,292) | -0.65% | -10.18% |
| GF0400 Vehicle License Fee | 79,774,000 | 23,210,832 | 23,692,504 | 481,673 | 2.08% | 6.10% |
| GF0500 Vehicle Registration Fee | 31,762,000 | 8,680,719 | 8,504,338 | (176,381) | -2.03% | 12.03% |
| GF0600 Nursing Facilities Fee | 5,704,000 | 1,467,799 | 1,411,478 | (56,321) | -3.84% | -0.34% |
| GF0700 Beer Tax | 3,058,000 | 1,037,183 | 1,057,484 | 20,300 | 1.96% | 10.34% |
| GF0800 Cigarette Tax | 34,993,000 | 2,748,033 | 14,782,654 | 12,034,621 | 437.94% | 178.25% |
| GF0900 Coal Severance Tax | 8,384,000 | 2,061,953 | 3,602,672 | 1,540,719 | 74.72% | -13.76% |
| GF1000 Corporation Tax | 64,762,000 | 16,007,144 | 16,368,527 | 361,383 | 2.26% | 46.73% |
| GF1100 Electrical Energy Tax | 4,408,000 | 1,056,498 | 1,062,031 | 5,532 | 0.52% | 6.73% |
| GF1150 Wholesale Energy Trans Tax | 3,432,000 | 852,938 | 689,224 | (163,714) | -19.19% | -2.83% |
| GF1200 Railroad Car Tax | 1,688,000 | 678,128 | 731,891 | 53,763 | 7.93% | 15.72% |
| GF1300 Individual Income Tax | 558,059,000 | 196,733,848 | 206,568,070 | 9,834,221 | 5.00% | 4.15% |
| GF1400 Inheritance Tax | 7,516,000 | 6,057,967 | 5,109,473 | (948,494) | -15.66% | -43.51% |
| GF1500 Metal Mines Tax | 2,967,000 | - | - | - | 0.00% | -35.31% |
| GF1700 Oil Severance Tax | 26,932,000 | - | - | - | 0.00% | -7.41% |
| GF1800 Public Contractor's Tax | 3,354,000 | 1,800,266 | 2,193,767 | 393,501 | 21.86% | 8.84% |
| GF1850 Rental Car Sales Tax | - | - | 1,012,729 | 1,012,729 | 0.00% | |
| GFxx00 Property Tax Levy | 174,311,000 | 7,451,657 | 11,350,673 | 3,899,016 | 2.24% | 1.53% |
| GF2150 Lodging Facilities Sales Tax | 8,807,000 | - | - | - | 0.00% | |
| GF2200 Telephone Tax | - | 33,498 | (257,323) | (290,821) | -868.17% | -100.00% |
| GF2250 Retail Telecom Excise Tax | 21,190,000 | 3,655,336 | 2,705,595 | (949,741) | -25.98% | 1.85% |
| GF2300 Tobacco Tax | 3,174,000 | 778,465 | 1,255,915 | 477,450 | 61.33% | 37.73% |
| GF2400 Video Gaming Tax | 45,012,000 | 11,010,794 | 12,386,748 | 1,375,954 | 12.50% | -1.71% |
| GF2500 Wine Tax | 1,283,000 | 450,318 | 490,980 | 40,662 | 9.03% | -4.24% |
| GF2600 Institution Reimbursements | 16,757,000 | 4,189,492 | 5,570,317 | 1,380,826 | 32.96% | 28.48% |
| GF2650 Highway Patrol Fines | 4,697,000 | 1,389,417 | 1,379,511 | (9,906) | -0.71% | 14.29% |
| GF2700 TCA Interest Earnings | 14,060,000 | 2,401,390 | 1,572,519 | (828,871) | -34.52% | 120.85% |
| GF2800 Local Impact Interest | - | - | - | - | 0.00% | |
| GF2900 Liquor Excise Tax | 10,239,000 | 3,571,282 | 3,739,174 | 167,892 | 4.70% | 1.96% |
| GF3000 Liquor Profits | 5,400,000 | - | - | - | 0.00% | -10.00% |
| GF3100 Coal Trust Interest Earnings | 37,187,000 | 9,721,269 | 7,095,590 | (2,625,680) | -27.01% | 2.45% |
| GF3300 Lottery Profits | 5,595,000 | - | - | - | 0.00% | -24.93% |
| GF3450 Tobacco Settlement | 3,105,000 | - | 29,482 | 29,482 | 0.00% | -83.40% |
| GF3500 U.S. Mineral Leasing | 23,469,000 | 6,684,800 | 5,861,335 | (823,465) | -12.32% | -9.70% |
| GF3600 Other Revenue | 36,254,000 | 9,907,850 | 10,214,647 | 306,798 | 3.10% | -18.17% |
| Total Revenue | $1,310,839,000 | $335,488,606 | $362,407,832 | $26,919,227 | 8.02% | 5.17% |

* House Joint Resolution 2 estimates as adjusted for enacted legislation.

This trend by itself indicates that general fund revenue growth may be above expectations since total revenues were expected to increase by 5.2 percent from actual fiscal 2003 to fiscal 2004 estimates. If the growth rate drops below 5.2 percent, the revenue estimate contained in House Joint Resolution 2 (HJR 2) will not be achieved. Estimated collections for fiscal 2004 are from HJR 2 adjusted for impacts of legislation enacted during the 58$^{th}$ Legislature.

While the growth rate of 8.0 percent is above the HJR 2 estimated rate of 5.2 percent, there are unusual events occurring between fiscal years that make this comparison misleading. For example, cigarette tax, lodging facilities sales tax, and rental car sales tax are not comparable to last year because of legislation enacted by the 58$^{th}$ Legislature. If these categories are adjusted for comparability, then total receipts would only be above last year by about 4.0 percent, considerably below the 8.0 percent shown in Table 1.

# DISCUSSION OF SELECTED REVENUE SOURCES FOR THE 2005 BIENNIUM

As explained in the previous section of the report, a comparison of total rev*enues from the previous fiscal year to the current fiscal year can be misleading. Not only can statutory modifications change revenue trends, but change in general economic conditions can also skew aggregate growth trends.

During fiscal 2004, several economic assumptions adopted by the 58th Legislature have not improved as anticipated. Although the revenues associated with these economic assumptions are below forecasts, collections in the later part of the year will probably not rebound even if economic conditions improve. This is due to the time lag between the economic changes and when the impacted tax revenues are actually received.

The following section of the report addresses selected revenue sources whose collections in fiscal 2003 were significantly different than estimated by the 58th Legislature. Table 2 shows these eighteen sources of revenue and the revenue estimate adjustments for the 2005 biennium. The adjustments portrayed are based on economic and accounting information received through November 2003.

**Table 2**
**Revenue Estimate Adjustments**
In Millions

| Source of Revenue | 2005 Biennium |
|---|---|
| Corporation Tax | (31.901) |
| TCA Interest Earnings | (18.724) |
| Property Tax Levy | (9.212) |
| Vehicle Registration Fee | (5.168) |
| Other Revenue | (5.070) |
| Insurance Tax | (3.474) |
| Coal Trust Interest Earnings | (3.078) |
| Coal Severance Tax | (0.319) |
| Institution Reimbursements | 0.000 |
| Investment Licenses | 0.151 |
| Inheritance Tax | 0.374 |
| Retail Telecom Excise Tax | 1.402 |
| Lottery Profits | 1.423 |
| US Mineral Royalties | 1.944 |
| Vehicle License Fee | 3.878 |
| Individual Income Tax | 3.948 |
| Video Gaming Tax | 7.312 |
| Oil & Gas Production Tax | 9.494 |
| Total | ($47.020) |

## **Corporation Tax -** ($31.9 million)

Corporation tax collections through November 2003 are slightly higher than the comparable period of 2002. The continued weakness in corporate income tax reflects the fiscal impact of the recession that occurred in 2001. Three factors that explain the significant changes in revenues are increased refunds, increased and extended bonus depreciation, and the effects of increased net operating losses (NOL).

Corporate refunds are well above the expected level of refunds, and there is a further expectation that several significant refunds will be made during fiscal 2004. Current refunds coupled with those unusually large refunds that are known suggest that HJR 2 is over-estimated by $17.0 million in fiscal 2004 and $11.6 million in fiscal 2005.

The 2003 Jobs and Growth Tax Relief Reconciliation Act increased the bonus depreciation provision, implemented in the 2002 economic stimulus plan, from 30 percent to 50 percent and extended it an additional year. The new provision will cause an additional decrease to HJR 2 estimates of $3.7 million in fiscal 2004 and $1.8 million in fiscal 2005.

Net operating losses (NOL) continue to reduce corporation license tax liabilities. While NOL carry-forward reductions were considered in the HJR 2 estimates, the effects have been nearly $1.0 million greater than expected in fiscal 2004. In fiscal 2005, NOL patterns are expected to return to a more normal pattern, increasing corporate tax revenues by over $3.0 million.

Combining the changes in refunds, extended bonus depreciation, and NOL carry-forwards corporate income tax collections are expected to be lower than HJR 2 estimates by $21.6 million in fiscal 2004 and $10.3 million in fiscal 2005.

## TCA Interest Earnings - ($18. 7 million)

Treasury cash account interest revenue is based on the amount of cash available to invest and the prevailing short-term interest rates. Both determining factors have declined. Cash balances in the account have decreased, necessitating the need to borrow more money for cash flow purposes than anticipated. In addition, the federal discount interest rate has plummeted from 6.0 percent in December 2001 to 0.75 percent in December 2002. Data from the Board of Investments show the yield on the treasury cash account for fiscal 2003 was 2.3 percent. The yield to date for fiscal 2004 is about 1.9 percent. This compares to the HJR 2 short-term interest rate assumption of 4.7 percent.

## Property Tax Levy - ($9.2 million)

Property tax revenues were $1.4 million above the estimate in fiscal 2003. This is probably due to higher than anticipated oil and natural gas prices during the first half of fiscal 2003. Before January 1, 2003, as enacted in HB 748, oil and natural gas revenues were distributed to the state property tax mills. HB 748 requires that these revenues now be distributed directly to the state general fund.

The current forecast of property tax revenues is $9.2 million below the HJR 2 forecast adjusted for legislation. HJR 2 estimates for the 2005 biennium included the impact of SB 294, which required that the state's share of taxes protested by the Pennsylvania and Power and Light Company from prior years and the current year be removed from an escrow account and deposited in the general fund. This was expected to be $8.5 million in fiscal 2004. However, in fiscal 2003, $3.8 million of the protested taxes were deposited in the general fund, thus reducing the amount available for deposit in fiscal 2004 by $3.8 million. The remaining $5.4 million reduction in property taxes reflects a smaller than anticipated tax base in tax year 2003, and slightly smaller growth rates for taxable value than were in HJR 2. The HJR 2 estimate and the current estimate both reflect the impacts of SB 461, the bill that phased in the new reappraisal values, tax rates and exemptions for commercial and residential property.

## Vehicle Registration Fee - ($5.2 million)

Revenue from vehicle registration fees was $0.6 million above estimate in fiscal 2003. More cars registered were the likely reason. The current forecast of vehicle registration fee revenue for the 2005 biennium is below the HJR2 legislation-adjusted amount by $5.2 million. This is primarily due to new information about the impacts of legislation passed during the 2003 legislative session. Specifically, a new fiscal note for SB118 was produced well after the 2003 session was over with $2.0 million less revenue than had been predicted previously. Effective January 1, 2003, SB 118 increased the license plate fees on new motor vehicles by $0.50, increased the generic specialty license plate administration fee, and delayed the issuance of new license plates. In addition, the executive has indicated that the revenue from SB 336 (a bill that instituted a new optional $4 fee on each light vehicle to be used to pay for operations at state parks, fishing access sites, Virginia City and Nevada City beginning January 1, 2004) will be deposited in a state special revenue account, not the general fund as the bill specifically states. The bill is expected to generate $3.2 million during the 2003 biennium.

## Other Revenue - ($5.0 million)

Changes to all other revenue are the result of increases in a number of minor sources and a decrease in a major one-time revenue source. Increases include $750,000 more than anticipated in security fraud settlements, a $1.0 million transfer from the orphan share account (this transfer was expected to occur in fiscal 2003 as directed by the HB 9 in the August 2002 special session, but actually occurred in fiscal 2004), and a $450,000 premium resulting from the sale of $73.4 million in tax revenue anticipation notes. House Bill 363 directed that $8.1 million of excess funds be transferred from the old state fund to the general fund in the 2005 biennium. State Fund officials estimate that only $815,000 will be available for transfer, a reduction of $7.3 million.

## Insurance Tax - ($3.5 million)

Insurance premiums tax is levied on the net premiums or gross underwriting profit for each insurance company operating in Montana. The premium growth assumptions adopted in HJR 2 were based on unusually high rates. Since insurance companies were experiencing reduced investment income due to the equity markets, premium rates were expected to increase significantly to compensate for the lower investment income.

Beginning in late fiscal 2003, a slowdown in premium growth was detected. These growth rates have continued into fiscal 2004 and are not expected to change materially in fiscal 2005. Total general fund revenues for the 2005 biennium are expected to be below HJR 2 estimates by $3.5 million for the 2005 biennium.

## Coal Trust Interest Earnings - ($3.1 million)

Coal trust interest earnings are generated from the investment of the coal severance tax trust fund. By statute, investment earnings from the coal trust interest earnings not earmarked to other programs are deposited to the general fund. While fiscal 2004 earnings were anticipated to increase from fiscal 2003, the collections for the first four months of fiscal 2004 are $2.6 million behind the comparable period of fiscal 2003. After adjusting for an accounting error made in October and other accounting differences between fiscal years, the shortfall for the 2005 biennium is expected to be $3.1 million. Lower interest earnings from investments in the short-term investment pool are the main reason for the reduction.

## Coal Severance Tax - ($0.3 million)

The coal severance tax is levied on each company's coal production in excess of 20,000 tons each year. Coal severance tax collections are expected to be below the HJR 2 forecasts by $319,000 for the 2005 biennium. The main reason for this decline is lower production amounts anticipated by one of the major coal producers in the state.

## Institution Reimbursements - $0.0 million

Adjustments in numerous assumptions have led to a change in revenue collections during the 2005 biennium for institution reimbursements. Most of the total change is captured in revisions to three major assumptions including the FMAP rates, Medicaid eligibility, and debt service expenses.

Changes in the expected FMAP rates were made in the Federal Jobs and Growth Tax Relief Reconciliation Act of 2003. The FMAP rate increases were instituted beginning in April 2003. As a result, the increased rates applied to the end of fiscal 2003 and through the third quarter of fiscal 2004. The effective annual FMAP rate for fiscal 2004 is 75.15 percent, or 2.18 percent greater than initially assumed. In fiscal 2005, the FMAP rate is now expected to be less than the HJR 2 assumptions. The fiscal 2005 FMAP assumption of 72.81 percent has been revised to 72.29 percent, a reduction of 0.52 percent points.

Changes in the number of Medicaid eligible patients at the Montana Mental Health Nursing Care Center and Montana Development Center have reduced reimbursement revenues for fiscal 2004 and fiscal 2005.

The bond issued for the Montana Developmental Center project was refinanced during fiscal 2003 creating a debt service savings of $247,055 for the 2005 biennium.

Combined, these changes are expected to increase institution reimbursements by $1.6 million in fiscal 2004, and reduce reimbursements by $1.6 million in fiscal 2005. Because the changes only alter the pattern of collection between the two fiscal years, there is no adjustment of HJR2 estimates for the biennium.

As a cautionary note, the state was informed last spring that 19 individuals at the Montana Developmental Center (MDC) in Boulder were being decertified as Medicaid eligible. This will result in the loss of reimbursements deposited to the general fund of about $2 million annually. Formal notification of decertification has not yet occurred. Thus, loss of Medicaid reimbursement for these individuals has not yet occured. The potential impact of this issue has not been incorporated into the revenue adjustments.

## Investment Licenses - $0.2 million

During fiscal 2003, investment license fees exceeded HJR 2 estimates by almost $575,000. After further analysis, it was determined that a $0.5 million settlement payment was recorded in this category during fiscal 2003. HJR 2 included this settlement payment in the "All Other Revenue" category. Based on this information, fiscal 2003 collections were slightly above the HJR 2 estimate. By continuing this trend into the 2005 biennium, collections should exceed the HJR 2 estimate by $151,000.

## Inheritance Tax - $0.4 million

Inheritance tax collections continue to be strong following the unpredictably high collections of 2003. While HJR 2 anticipated reduced collections as the federal estate tax is eliminated, revenues in fiscal 2004 are only $350,733 below fiscal 2003 collections for the same period. Careful analysis of inheritance tax collections show that in fiscal 2004, normal collections have fallen off substantially, yet two large estates with tax liabilities in excess of $1.0 million were settled. As a result, inheritance taxes are expected to be greater than the HJR 2 estimates by $0.374 million in fiscal 2004. No changes are expected in fiscal 2005.

## Retail Telecom Excise Tax - $1.4 million

Revenue from the retail telecom excise tax exceeded the estimate by $0.7 million in fiscal 2003. Due to a higher starting base in fiscal 2003, the current forecast for this revenue source for the 2005 biennium exceeds the HJR 2 adjusted amount by $1.4 million.

## Lottery Profits - $1.4 million

All gross lottery revenue not used for prizes, commissions, and operating expenses is considered net revenue. Total net revenue (including interest earned on the proprietary account) is transferred to the general fund. For the past two fiscal years, annual lottery revenue transfers to the general fund have exceeded $7.4 million.

According to the lottery director, fiscal 2003 collections of $7.5 million were somewhat unusual because of unique events that are not anticipated in the future. Fiscal 2004 and 2005 collections are expected to be slightly less at $7.0 million per year. The introduction of several new games beginning early next calendar year is expected to bolster net revenue transfers by about $1.4 million for the 2005 biennium.

## US Mineral Royalty - $1.9 million

US mineral royalty collections through October 2003 are $1.0 million above the comparable period for fiscal 2003. Higher natural resource prices, particularly oil and natural gas, increase the amount of royalties Montana receives from these commodities above HJR 2 estimates by $1.9 million. It should be noted that HB 226 passed by the 57th Legislature transfers 12.5 percent of US mineral royalty revenue deposited to the general fund in fiscal 2004 and 25 percent in fiscal 2005 to the counties where the mining or extraction occurred. Therefore, although higher natural resource prices result in additional general fund revenue, disbursements from the general also increase by an estimated $357,000.

## Vehicle License Fee - $3.8 million

Revenue from vehicle taxes was $0.4 million above the estimate for fiscal 2003. Likely, some of this was due to dealer incentives increasing the purchase of new cars. The current forecast of vehicle tax revenue for the 2005 biennium exceeds the HJR 2 adjusted amount by $3.9 million. This reflects a higher fiscal 2003 starting base, and a higher growth rate of 1.6 percent per year when compared with the growth rates in HJR 2. The forecast includes a $7.9 million biennial impact of HB 559, which allows for a one-time lifetime flat fee on watercraft, snowmobiles, motorcycles, quadricycles, and trailers, effective January 1, 2004.

## **Individual Income Tax -** $3.9 million

Income tax receipts for the 2005 biennium are $3.66 million above estimates in HJR 2 adjusted for legislation. The new estimate is based on collections through November 2003.

Gross collections (actual collections plus refunds added back) through November of 2003 were 1.7 percent above gross collections through November 2002. This increase was applied to total year gross collections in fiscal 2003 to derive a forecast of gross collections in fiscal 2004.
Gross collections in fiscal 2004 were adjusted downward by the estimate of refunds in fiscal 2004. This downward adjustment was 23 percent, the ratio of refunds to gross collections observed in fiscal 2002. Refunds in fiscal 2003 appear to have been unusual in that more returns were filed in October 2002 than normal.

The fiscal 2004 income tax estimate after refunds was further adjusted by the estimated impacts of legislation passed during the 2003 legislative session and by the impacts of the federal Jobs and Growth Tax Relief Reconciliation Act, enacted in May 2003 (see below).

The new estimate of fiscal 2005 income tax collections is the same as the HJR 2 estimate adjusted for legislation that was published at the end of the 2003 legislative session, plus the impact of the federal Jobs and Growth Tax Relief Reconciliation Act enacted in May 2003.

### **Impact of Federal Tax Relief on State Income Tax Revenues**

In May of 2003, the federal Jobs and Growth Tax Relief Reconciliation Act of 2003 was signed into law. This act accelerated the phased-in tax relief that had been passed in 2002, the Jobs Creation and Workers Assistance Act, hereafter referred to the 2002 law. The Jobs and Growth Tax Relief Reconciliation Act accelerated tax rate reductions on ordinary income, accelerated the provisions dealing with marriage penalty relief, the expansion of the 10 percent bracket, the child tax credit, reduced tax rates on capital gains and dividends, and increased business deductions.

State income tax receipts as a result of the Act will increase by approximately $23 million during the 2005 biennium. The provisions of the act are as follows:

?? Reduce capital gains tax rates for long term gains to 15 percent and tax rates on dividends to 15 percent – this will increase state income tax collections as state taxpayers claim less federal taxes deductible.

?? Accelerate federal tax rate reductions – instead of phasing-in the reduction in federal tax rates over many years, as the 2002 federal law required, the rates that would have been in effect in tax year 2006 will apply tax year 2003. This will increase state income tax collections as state taxpayers claim less federal taxes deductible.

?? Expansion of 10 percent bracket – under the 2002 federal tax changes, the expansion of the 10 percent bracket was to have taken place in tax year 2008. The Act implements this beginning in tax year 2003. However, this provision ends beginning in tax year 2005 and the prior phase-in will resume. This will increase state income tax collections.

?? Marriage penalty relief – under the 2002 federal tax changes, marriage penalty relief was to be phased-in with full phase-in taking place in tax year 2009. Under the Act, the 2009 relief is available in tax years 2003 and 2004. In tax year 2005, the relief reverts to the 2002 law phase-in amounts. This will increase state income tax collections.

?? Expansion of the child tax credit – under the 2002 federal tax changes, the child tax credit was to be phased-in until it was $1,000 in tax year 2010. The Act raises the child tax credit to $1,000 in tax years 2003 and 2004, after which it reverts to the 2002 law phase-in amounts. This will increase state income tax collections.

- ?? Alternative minimum tax exemptions – the Act temporarily raises the exemption amount in tax years 2003 and 2004, after which the exemption amounts revert to their previous level. This will increase state income tax collections.
- ?? Increase deduction amounts for code 179 expensing – this raises the amount that can expensed in one year to $100,000 from the current amount $25,000, for tax years 2003 through 2005. Because the state income tax system follows federal tax rules regarding expensing, this provision will decrease state tax revenues.
- ?? Increase bonus depreciation to 50 percent in first year of life of equipment for equipment purchased between May 1, 2003 and January 1, 2005 -the 2002 law allowed a 30 percent bonus depreciation in the first year after purchase. This provision will decrease state tax revenues.

### Video Gaming Tax - $7.3 million

Video gambling revenue is derived from two sources: license fees and video gambling taxes. The fifteen percent tax on gross income less payouts produces the majority of the collections from this source. Based on revenue growth from fiscal 2002 to 2003 and conversations with the Gambling Control Division, Department of Justice, collections for the 2005 biennium are expected to exceed the HJR 2 estimate by $7.3 million. The HJR 2 growth assumptions were premised on a peak in machine play with growth abated from historical levels. Current collection trends do not support this assumption.

### Oil & Gas Production Tax - $9.5 million

Revenue from oil and natural gas production taxes was $7.4 million above the estimate for fiscal 2003, primarily due to much higher prices for both commodities. Also, special low tax rates for incentive production were increased temporarily in the 2nd quarter of fiscal 2003 because the price of West Texas Intermediate oil was above $30 per barrel. Current law requires these incentive tax rates be increased each quarter that WTI is above $30 per barrel. The current forecasts of oil and natural gas production tax revenues during the 2005 biennium exceed those in HJR 2 by $9.5 million. This is primarily due to higher forecasts of oil and natural gas prices.

Montana prices for oil and natural gas in fiscal years 2004 and 2005 are now expected to be substantially above prices in HJR 2. The HJR 2 prices for the two years of the 2005 biennium were between $21.00 and $22.00 per barrel for oil, and between $2.80 and $2.90 per MCF for natural gas. Currently, the forecasts for oil prices are $27.00 for fiscal 2004 and $24.50 for fiscal 2005. The current forecasts for natural gas are $3.50 for fiscal 2004 and $3.20 for fiscal 2005. These are consistent with futures prices for these commodities. In addition, current forecast production levels for oil are around 2.2 million barrels above HJR 2 levels. However, current forecast production levels for natural gas are below those in HJR 2 by 16 million MCF in fiscal 2004 and by 18 million MCF in fiscal 2005. This is due to a reduction in the 2003 natural gas production base of around 13 million MCF below the HJR 2 estimate.

## DISBURSEMENT ISSUES FOR THE 2005 BIENNIUM

### Children's Health Insurance Program (CHIP)

In November 2003, the Governor approved the use of $609,000 general fund to eliminate the waiting list for CHIP. These excess funds were available because of the FMAP rate increase included in the Jobs and Growth Tax Relief Reconciliation Act.

### Statutory Appropriations and Transfers

Statutory Appropriations – Statutory appropriations for debt service and transactional costs associated with the issuance of tax revenue anticipation notes (TRANS) are reduced by $1.2 million over the biennium because of a more favorable interest rate received for the fiscal 2004 issue and the even better rate expected in fiscal 2005. Although the issue sizes are larger, the lower than expected interest rates more than off-set the additional costs of larger issues.

Transfers – Transfers out of the general fund decrease by $2.8 million due to the net result of two factors: 1) HB 226 passed by the 57th Legislature transfers 12.5 percent in fiscal 2004 and 25 percent in fiscal 2005 of US mineral royalty revenue deposited to the general fund to the counties where the mining or extraction occurred. Because higher natural prices result in additional general fund revenue from US mineral royalties, disbursements from the general fund also increase an estimated $357,000; and 2) SB 336 passed by the 58th Legislature provided for an additional optional $4.00 vehicle registration fee to be used for state parks, fishing access sites, and state owned facilities at Virginia City and Nevada City. The legislation requires the revenue, estimated to be $3.2 million over the biennium, be deposited to the general fund and then transferred to Department of Fish, Wildlife and Parks' state special revenue account. For the 2005 biennium, the executive will not deposit the revenue to the general fund, but instead will deposit the revenue directly to the state special revenue account. Therefore, the transfer of $3.2 million out of the general fund will not occur.

## Supplemental Appropriations

### Public Schools

The expected general fund supplemental for the K-12 distribution program is $8.8 million during the 2005 biennium. The supplemental appropriation is the result of higher costs in fiscal 2004 and 2005, and an expected shortfall in interest and income revenue from school trust lands in each year of the 2005 biennium.

Revenue Shortfall - Income (state special revenue) from common school trust lands is increasing due to higher natural resource prices, particularly oil and natural gas. However, the increase is mitigated due to lower than anticipated coal prices for a net increase of $956,000 over the biennium. The increase in mineral royalty revenue is more than offset by a reduction in investment earnings from the permanent trust balance. Even though fiscal 2004 earnings were anticipated to increase from fiscal 2003, the first three months of fiscal 2004 are $310,000 below the comparable period of fiscal 2003. If earnings continue at the current pace, revenues will be reduced $4.0 million over the biennium. Because general fund covers any shortfall in state special revenue from school trust lands to maintain total state funding at the statutorily required level, the reduction in state special revenue increases general fund expenditures by the same amount or an estimated net $3.1 million for the 2005 biennium.

Cost Overruns - Data from school district budgets for fiscal 2004 indicate that fiscal 2004 general fund costs for direct state aid and guaranteed tax base (GTB) will exceed estimates by around $3.0 million. The reason for this increase is probably due to less fund balance carryover from fiscal 2003 than anticipated. This is likely due to lower collections of property tax from PPL, which protested its taxes, and from Northwestern, which did not pay Spring 2003 taxes until Fall 2003. The enrollment count for October 2003, which forms the basis for the ANB count used in fiscal 2005, indicates that ANB in fiscal 2005 will be 1,000 students more than anticipated. As a result, general fund distribution costs are anticipated to be $2.7 million higher than originally thought.

### Corrections

At this time, cost overruns for the Department of Corrections are not expected in fiscal 2004. However, while fiscal 2004 expenditures should stay within the appropriation, there is cause for concern about expenditures in fiscal 2005. Upward trends in population, including currently higher than anticipated totals in more expensive destinations such as secure care, will put additional pressures on expenditures.

### Human Services

At this time, a supplemental appropriation is not expected for Public Health and Human Services. In addition, the department is not anticipating using any of the remaining $18.4 million federal FMAP rate change funds. Nonetheless, there are two primary areas of concern: 1) the population at Montana State Hospital; and 2) the state's inability to meet the maintenance of effort to receive the federal mental health block grant. Both of these issues could evolve into a supplemental appropriation situation.

## Summary

Table 3 is a summarization of the LFD adjustments to the 2005 biennium general fund budget as adopted by the 58th Legislature. Items 1 through 5 shown in the table were discussed in a previous report issued in October 2003. Items 6 through 9 reflect adjustments that have been previously discussed in this report.

**Table 3**
**2005 Biennium General Fund Budget**
**LFD Adjustments (In Millions)**

| | Budgetary Item | 2005 Biennium |
|---|---|---|
| | Previously Addressed in October: | |
| 1 | Unanticipated Fiscal 2003 Balance | $29.883 |
| 2 | Federal Relief FMAP Increase * | 19.029 |
| 3 | US Mineral Royalty Transfer | (4.674) |
| 4 | Continuing Appropriations | (2.086) |
| 5 | Debt Service | 1.411 |
| | Updated Information Since October | |
| 6 | Revenue Estimate Adjustments | (47.020) |
| 7 | Childrens Health Insurance Program | (0.609) |
| 8 | Public Schools Supplemental | (8.832) |
| 9 | Statutory Appropriations & Transfers | 3.875 |
| | Total Adjustments | ($9.023) |
| | Anticipated Ending Fund Balance | 46.218 |
| | **Revised Ending Fund Balance** | **$37.195** |

* Adjusted for FMAP Increase included in fiscal 2003 ending fund balance

As shown in Table 3, total adjustments amount to a negative $9.0 million. With these adjustments, the 2005 biennium general fund ending balance is projected to be $37.2 million as compared to $46.2 million anticipated by the legislature.

It should be noted that neither the $50 million in federal Jobs and Growth Tax Relief Reconciliation Act monies nor the wildfire suppression costs are included in this table. This is because these funds are deposited in a federal account and the wildfire costs are paid from this federal account. The next section of the report combines the federal grant monies with the general fund to provide a complete financial picture.

## 2005 Biennium General Fund Balance Sheet

Table 4 shows the revised 2005 biennium estimated ending fund balance for the general fund account. The projected general fund ending fund balance for the 2005 biennium of $37.2 million is $9.0 million less than the amount estimated at the end of the 58th legislative session. This balance incorporates actual revenue and disbursement data for fiscal 2003 and includes revenue and disbursement estimates for the 2005 biennium as budgeted by the 58th Legislature. Also included in this balance are adjustments that have been discussed in this report.

| Table 4<br>2005 Biennium General Fund Balance<br>Action By the 58th Legislature With Fiscal 2004 & 2005 Adjustments<br>In Millions | Actual<br>Fiscal 2002 | Preliminary<br>Fiscal 2003 | Preliminary<br>2003 Biennium | Estimated<br>2005 Biennium |
|---|---|---|---|---|
| **Beginning Fund Balance** | **$172.897** | **$81.316** | **$172.897** | **$46.404** |
| **Revenues** | | | | |
| Current Law Revenue | 1,265.713 | 1,246.381 | 2,512.094 | 2,490.879 |
| Legislation Impacts | 0.000 | 0.000 | 0.000 | 107.996 |
| Residual Transfers | 0.000 | 0.000 | 0.000 | 0.000 |
| **Total Revenue** | **$1,265.713** | **$1,246.381** | **$2,512.094** | **$2,598.875** |
| **Total Funds Available** | **$1,438.610** | **$1,327.697** | **$2,684.991** | **$2,645.279** |
| **Disbursements** | | | | |
| General Appropriations | 1,120.576 | 1,082.513 | 2,203.089 | 2,319.761 |
| Statutory Appropriations | 149.108 | 132.347 | 281.455 | 254.482 |
| Local Assistance Appropriations | 0.000 | 0.000 | 0.000 | 0.000 |
| Miscellaneous Appropriations | 68.016 | 84.423 | 152.439 | 6.350 |
| Language Appropriations | 0.000 | 0.000 | 0.000 | 0.646 |
| Non-Budgeted Transfers | 18.768 | 3.150 | 21.918 | 31.165 |
| Continuing Appropriations | 2.611 | 3.368 | 5.979 | 2.086 |
| Supplemental Appropriations | 0.000 | 0.000 | 0.000 | 8.832 |
| Wildfire Costs | 0.000 | 0.000 | 0.000 | 0.000 |
| Feed Bill Appropriations | 0.000 | 0.000 | 0.000 | 6.699 |
| Anticipated FMAP Reversions | | | | (18.420) |
| Anticipated Reversions | (3.176) | (29.974) | (33.150) | (8.191) |
| **Total Disbursements** | **$1,355.903** | **$1,275.827** | **$2,631.730** | **$2,603.410** |
| **Adjustments** | (1.391) | (5.466) | (6.857) | (4.674) |
| **Unreserved Ending Fund Balance** | **$81.316** | **$46.404** | **$46.404** | **$37.195** |
| **Federal Grant Monies** | | | | |
| Federal Relief Grant Funds | | 25.000 | 25.000 | 25.000 |
| State Net WildFire Costs | | | 0.000 | (35.792) |
| Governor's Spending Proposal | | | 0.000 | (11.064) |
| **Unreserved Ending Fund Balance + Federal Grant Monies** | | **$71.404** | **$71.404** | **$40.339** |

As shown in Table 4, total 2005 biennium revenues are anticipated to be $2.599 billion while total disbursements for the same period are expected to be $2.603 billion or a difference of approximately a negative $4.5 million. This amount has not been adjusted for one-time revenues or disbursements. If revenues for the 2005 biennium do not improve above the amount shown in Table 4, a structural imbalance condition will occur. Depending on the magnitude of the imbalance, the next legislature could be faced with another challenging budget session (See “2007 Biennium General Fund Outlook” at the end of this report). Shown at the bottom of Table 4 is the impact on state finances when the federal relief grant funds and the current net state wildfire costs are combined with the general fund account. Between net state wildfire costs ($28.7 million fiscal 2004 and $7.1 million fiscal 2005) and the Governor’s spending proposal ($11.1 million), only $3.1 million remains of the federal Jobs and Growth Tax Relief Reconciliation Act funds. This explains why the balance increases from $37.2 million to $40.3 million. This distinction is necessary because the federal grant monies are deposited to a federal account and the current wildfire costs are being paid from this federal account.

Table 5 shows the state's financial condition when the general fund account is combined with federal grant funds. This table is categorized by "current known fiscal issues", "current estimated other fiscal issues", and "current unknown other fiscal issues". While the amounts for certain items in this table are exactly the same as in Tables 3 and 4, this table summarizes the financial information in way that provides a clear perspective on the amounts that are known versus the amounts that are estimated or totally unknown. At the bottom of the table, the amount of a negative $5.9 million is shown that represents an estimate of the fund balance below the legislative adopted amount of $46.2 million.

Included in the calculation of the projected ending fund balance is the estimated state wildfire costs for the 2003 season from the Department of Natural Resources and Conservation. These cost estimates were as of November 21, 2003. The projected balance also includes an estimate for 2004 state wildfire costs based on a five-year average over the period 1998 through 2002.

**Table 5**
**General Fund Account Plus Federal Grant Funds (In Millions)**
**Change in Fund Balance**

| Budgetary Item | | 2005 Biennium |
|---|---|---|
| **Budgeted Ending Fund Balance** | | **$46.218** |
| Current Known Fiscal Issues | | |
| Federal Relief Grant Funds (Fed $) | 50.000 | |
| Federal Relief FMAP Increase * | 19.029 | |
| Unanticipated Fiscal 2003 Balance | 29.883 | |
| Sub Total | | $98.912 |
| US Mineral Royalty Transfer | | (4.674) |
| Continuing Appropriations | | (2.086) |
| Debt Service | | 1.411 |
| Childrens Health Insurance Program | | (0.609) |
| Governor's Spending Proposal (Fed $) | | (11.064) |
| Current Estimated Other Fiscal Issues | | |
| Revenue Estimate Adjustments | | (47.020) |
| State Wildfire Costs 2003 Season (Net) (Fed $) | | (28.747) |
| State Wildfire Costs 2004 Season (Net) (Fed $) | | (7.045) |
| Statutory Appropriations & Transfers | | 3.875 |
| Public Schools Supplemental | | (8.832) |
| Current Unknown Other Fiscal Issues | | |
| Other Potential Supplementals | | |
| Legislative Audit Adjustments to Fiscal 2003 | | |
| Pending Litigation | | |
| Potential Ending Fund Balance | | $40.339 |
| Budgeted Ending Fund Balance | | 46.218 |
| **Change In Fund Balance** | | **($5.879)** |

* Adjusted for FMAP Increase included in fiscal 2003 ending fund balance

# EXPENDITURE REDUCTIONS UNDER 17-7-140, MCA

As previously explained, the general fund account may end the 2005 biennium with a balance of $37.2 million or $9.0 million less than anticipated by the 58th Legislature. It should be emphasized that this projected balance includes $98.9 million (shown in Table 5) of additional funds that were not anticipated by the 58th Legislature. In other words, without these additional funds, the projected general fund balance at the end of the 2005 biennium would be a negative $62 million.

Under Title 17-7-140, MCA, the Governor is required to "ensure that the expenditure of appropriations does not exceed available revenue". If revenue projections worsen or 2004 wildfire suppression costs or supplemental appropriations are greater than shown in Table 5, the executive may be required to implement expenditure reductions as outlined under 17-7-140, MCA. As stated in this section of law, "a "projected general fund budget deficit" means an amount, certified by the budget director to the governor, by which the projected ending general fund balance for the biennium is less than 2% of the general fund appropriations for the second fiscal year of the biennium." Two percent of the general fund appropriations for the second year of the biennium would be approximately $26 million. As amended by the last legislature, 17-7-140 (3i) reduces the trigger amount as the biennium nears the end. This phased-in reduction of the trigger begins in October 2004. The following is the applicable section of statute that addresses the roles and responsibilities of the executive, the Legislative Finance Committee, and the Revenue and Transportation Interim Committee (RTIC).

*17-7-140.*
*Reduction in spending. (1) (a) As the chief budget officer of the state, the governor shall ensure that the expenditure of appropriations does not exceed available revenue. Except as provided in subsection (2), in the event of a projected general fund budget deficit, the governor, taking into account the criteria provided in subsection (1)(b), shall direct agencies to reduce spending in an amount that ensures that the projected ending general fund balance for the biennium will be at least 1% of all general fund appropriations during the biennium. An agency may not be required to reduce general fund spending for any program, as defined in each general appropriations act, by more than 10% during a biennium. Departments or agencies headed by elected officials or the board of regents may not be required to reduce general fund spending by a percentage greater than the percentage of general fund spending reductions required for the total of all other executive branch agencies. The legislature may exempt from a reduction an appropriation item within a program or may direct that the appropriation item may not be reduced by more than 10%.*

*(b) The governor shall direct agencies to manage their budgets in order to reduce general fund expenditures. Prior to directing agencies to reduce spending as provided in subsection (1)(a), the governor shall direct each agency to analyze the nature of each program that receives a general fund appropriation to determine whether the program is mandatory or permissive and to analyze the impact of the proposed reduction in spending on the purpose of the program. An agency shall submit its analysis to the office of budget and program planning and shall at the same time provide a copy of the analysis to the legislative fiscal analyst. The office of budget and program planning shall review each agency's analysis, and the budget director shall submit to the governor a copy of the office of budget and program planning's recommendations for reductions in spending. The budget director shall provide a copy of the recommendations to the legislative fiscal analyst at the time that the recommendations are submitted to the governor and shall provide the legislative fiscal analyst with any proposed changes to the recommendations. The legislative finance committee shall meet within 20 days of the date that the proposed changes to the recommendations for reductions in spending are provided to the legislative fiscal analyst. The legislative fiscal analyst shall provide a copy of the legislative fiscal analyst's review of the proposed reductions in spending to the budget director at least 5 days before the meeting of the legislative finance committee. The committee may make recommendations concerning the proposed reductions in spending. The governor shall consider each agency's analysis and the recommendations of the office of budget and program planning and the legislative finance committee in determining the agency's reduction in spending. Reductions in spending must be designed to have the least adverse impact on the provision of services determined to be most integral to the discharge of the agency's statutory responsibilities.*

*(2) Reductions in spending for the following may not be directed by the governor:*

*(a) payment of interest and principal on state debt;*

*(b) the legislative branch;*

*(c) the judicial branch;*

*(d) the school BASE funding program, including special education;*

*(e) salaries of elected officials during their terms of office; and*

*(f) the Montana school for the deaf and blind.*

*(3) (a) As used in this section, "projected general fund budget deficit" means an amount, certified by the budget director to the governor, by which the projected ending general fund balance for the biennium is less than:*

*(i) 2% of the general fund appropriations for the second fiscal year of the biennium prior to October of the year preceding a legislative session;*

*(ii) 3/4 of 1% in October of the year preceding a legislative session;*

*(iii) 1/2 of 1% in January of the year in which a legislative session is convened; and*

*(iv) 1/4 of 1% in March of the year in which a legislative session is convened.*

*(b) In determining the amount of the projected general fund budget deficit, the budget director shall take into account revenue, established levels of appropriation, anticipated supplemental appropriations for school equalization aid, and anticipated reversions.*

*(4) If the budget director determines that an amount of actual or projected receipts will result in an amount less than the amount projected to be received in the revenue estimate established pursuant to 5-5-227, the budget director shall notify the revenue and transportation interim committee of the estimated amount. Within 20 days of notification, the revenue and transportation interim committee shall provide the budget director with any recommendations concerning the amount. The budget director shall consider any recommendations of the revenue and transportation interim committee prior to certifying a projected general fund budget deficit to the governor.*

In summary, the projected ending fund balance for the general fund at the end of the 2005 biennium is $37.2 million or $11.2 million above the expenditure reduction trigger. This projected balance includes a supplemental appropriation for public schools, but no supplemental appropriations for all other state agencies. Because the projected ending balance is very close to the statutorily defined $26 million trigger, small changes in expenditures or revenues in a negative direction may require the executive to implement the provisions of the "reduction in spending" statute delineated in 17-7-104, MCA. To illustrate the tenuous situation of the state, the executive would be required to implement reductions in spending if revenue collections slip an additional 0.5 percent or next year's fire season is similar to this year.

# 2007 BIENNIUM GENERAL FUND OUTLOOK

The 58th Legislature experienced a substantial general fund budget deficit of over $208 million for the 2005 biennium. This amount represented the "present law" general fund dollars unavailable to fund government services at the level authorized by the 57th Legislature. The 58th Legislature erased the deficit through expenditure reductions and the enactment of numerous pieces of other legislation. When aggregated by broad budgetary categories, the solution was crafted with a combination of enhancing revenues by $130.0 million, reducing disbursements by $74.2 million, and reducing the ending fund reserve by $3.8 million. Of the $130 million in revenue enhancements, over $100 million could be considered "one-time" and will not be available in the 2007 biennium.

In addition to the $100 million, the 2005 biennium revenues are expected to be below expectations by nearly $50 million (see the previous sections in this report). This is anticipated revenue that was used in balancing the 2005 biennium budget. Effectively, the general fund revenue base has been reduced until economic conditions improve.

As discussed in the "Legislative Fiscal Report, 2005 Biennium", the 59th Legislature will be faced with financial issues that are either statutory or policy driven. Statutory issues are budget items that are defined by current statute (employee pay, public school inflation adjustments, etc.). These issues must be funded during the 2007 biennium unless statutory changes are adopted by the next legislature. Policy driven issues are issues adopted by the 2003 Legislature that the legislature may have some discretion in modifying based on adopted policies. An estimate of the combined impacts of statutory and policy issues for the 2007 biennium is about $85 million.

Combining the $100 million in unavailable revenue with the $50 million in reduced 2005 biennium revenues and the $85 million in statutory and policy driven issues, the general fund revenue growth rate in the 2007 biennium will need to be sufficient enough to increase revenues by $235 million. Unless the state experiences unusually high economic growth in the future, these funds may not be totally recouped in the 2007 biennium. To what extent state and national economies increase, will determine how much of the $235 million will be mitigated by revenue growth. If growth is below $235 million, the 59th Legislature will have to face policy issues of raising taxes, reducing expenditures, or a combination of both.

As explained above, the 2005 Legislature could be faced with an extremely difficult budget session. It should be noted that these calculations are very preliminary and are based on a limited amount of information that is currently available. National and state economic growth, federal policies, and world events could change this outlook either positively or negatively.