LFD GENERAL FUND
PRELIMINARY BUDGET OUTLOOK
“BIG PICTURE REPORT”
2005 BIENNIUM

A Report Prepared for the

57th Legislature

By the

Legislative Fiscal Division

September 26, 2002

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INTRODUCTION

PURPOSE OF REPORT

The purpose of this report is to provide the Legislative Finance Committee (LFC), the Revenue and Transportation Committee, and the members of the legislature with a preliminary projection of the general fund balance for the 2005 biennium at present law levels of revenue and expenditure. The projection will estimate the availability of funding for maintenance of existing services as well as for new and expanded programs. This report is intended to provide a broad overview of the scope of present law fiscal issues the legislature may face in the 2003 session, and the starting point, or benchmark for crafting the 2005 biennium budget priorities. These projections are based on "broad brush" general assumptions of expenditure and revenue patterns from the most current available information, and will be refined as staff undertakes detailed budget analysis and revenue estimation in preparation for the 2003 legislative session.

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

SCOPE OF REPORT

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

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

Specifically, the projections do not include other fiscal issues that may face the 2003 legislature, including executive or legislative new proposals/initiatives, property tax reappraisal, reductions in services that would require a switch to general fund to continue, other potential fiscal 2003 supplementals, pending litigation, or the potential impact of voter initiatives.

2005 BIENNIUM BUDGET PROJECTION

PROJECTED GENERAL FUND DEFICIT

Present Law

The projected present law ending general fund balance for the 2005 biennium is a negative $225.8 million, and grows to a negative $249.5 million when allowing for a 2 percent ending fund balance reserve. This represents an available balance (shortfall) for policy decisions on prioritization of present law expenditures, new initiatives, tax reform, and an appropriate general fund reserve. This outlook provides a stark contrast from the $53.8 million balance the 2001 legislature originally anticipated at the end of the 2003 biennium, and leaves insufficient funds to even continue existing programs and services at current levels. The primary reasons that have contributed to this decline are a significant decline in actual and projected general fund revenue collections (primarily income taxes) and an increase in present law human services, corrections, and other costs.

Table 1
2005 Biennium General Fund Outlook
In Millions

Beginning Fund Balance		**$27.152**
Anticipated Revenue		**$2,595.073**
Disbursements		
Additional Fiscal 2003 Supplementals		6.200
Fiscal 2002 Base times 2 (Excl. stat. approps.)		2,343.158
Present Law Adjustments		168.448
Public Schools	(9.838)	
Public Health	76.346	
Corrections	11.095	
Higher Education	6.574	
Pay Plan	36.395	
District Court Assumption	38.901	
Other Adjustments	8.975	
Fiscal 2002 Base times 2 (Stat. approps. + trnf.)		335.754
Statutory Appropriations		(31.177)
Transfers		(2.598)
Total Disbursements		**$2,819.785**
Projected Deficit Without a Reserve		(197.560)
Statutory Minimum Ending Fund Balance Reserve		28.198
Projected Present Law Deficit		**($225.758)**

LFD Suggested Allowance For Adequate Reserve	**$23.703**
2% Reserve = $51.9M with $28.1M minimum)	
Projected Deficit With Adequate Reserve	**($249.461)**

Other Significant Issues Not Addressed Above
- Property Reappraisal
- Temporary Assistance for Needy Families
- Child Support Enforcement Division
- District Court Funding
- Other Potential Fiscal 2003 Supplementals
- Ballot Initiatives
- Department of Public Health & Human Services Lawsuit
- Public Schools K-12 Lawsuit
- Personal Property Tax Rate Trigger
- Economic Uncertainty and Revenue Trends

The provision of a present law budget projection represents a starting point for legislative budget deliberations, and complements the statutory requirement that the executive and legislative staff present/analyze a present law budget. Present law is defined as "that level of funding needed under present law to maintain operations and services at the level authorized by the previous legislature…" Present law serves as a benchmark to aid the legislature in prioritizing budget issues between maintenance of existing services and provision of new services. The projection of a present law budget does not presume the legislature will adopt a budget that retains all existing services, and in this case, it is clear that available present law funds will not support continuation of existing present law services. But the executive must present a present law budget to the 2003 legislature, and both new initiatives and reductions or adjustments in existing services must by law be presented as new proposals for the legislature to consider in crafting a budget.

Ending Fund Balance Reserve

An ending fund balance reserve provides a cushion for unexpected expenditures (supplementals/statutory appropriations) and variations in actual revenue collections versus projections. Statute requires a minimum ending fund balance reserve of 1 percent of total appropriations, or approximately $28 million for a present law budget. When this minimum reserve is included in the projections, it leaves a projected present law deficit of $225.8 million. It would not be good budget management, however, to leave an ending fund balance projection that only meets the minimum, since any negative decline from projections would trigger statutorily required budget balancing action by the executive. Plus, a 1 percent reserve for a biennial budget that is subject to significant fluctuations in revenue estimates (a state revenue projection within 3 percent of actual collections is generally considered good) and expenditure increases simply does not provide an adequate cushion for unanticipated events.

Recently, the general fund reserve set by the legislature has been above $50 million, or approximately 2 percent of total biennial revenues. A general fund reserve of at least 2.5 percent of total biennial revenues is considered prudent by national budget experts. The calculation of the target ending fund balance -- based on 2.5 percent of total biennial general fund revenues as "recommended" by budget experts -- results in a budget reserve of $65 million.

While a minimum reserve of 2.5 percent is recommended, it is recognized that in the current budget crisis, it would be difficult to attain. Yet an adequate fund balance reserve is even more important and prudent in economically unstable times. The Legislative Fiscal Division (LFD) suggested minimum adequate ending fund balance reserve is 2 percent, or nearly $52 million. This amount is consistent with the amount adopted by the 2001 legislature for the 2003 biennium. This does, however, increase the projected deficit to $249.5 million. This suggested fund balance reserve is only a guideline and is included to provide a more realistic measure of the deficit that the 58th Legislature faces. Ultimately, the determination of an adequate fund balance reserve is a policy decision of the legislature.

Executive / Special Session Reductions (Fiscal 2003)

The projected ending fund balance shown in Table 1 assumes funding of all present law services at the level funded by the 57th Legislature in the 2001 regular session, and removal of permanent statutory reductions in the August 2002 Special Session. It does not reflect any of the non-permanent reductions in special session or the Governor's spending reductions. Present law is defined as "that level of funding needed under present law to maintain operations and services at the level authorized by the previous legislature…" The Tables in the table are designed to show the costs of maintaining services at the level provided in the base year as determined by the 2001 legislature. Consequently, the projections do not include continued implementation of actions to reduce expenditures in fiscal 2003 if the legislature was not clear that the action now constituted long-term legislative policy-making. Therefore, almost $94 million of potentially ongoing reductions from the special session are not reflected in the projections, since they do not meet the customary definition of a present law. However, if the 2003 legislature were to continue all of those reductions, it would leave $156 million to be resolved by other budget balancers. It must be emphasized that these reductions would be difficult to achieve, since a number of the reductions were only intended as a one-time action for a variety of reasons, including use of a one-time alternative source of funds (e.g., the use of over $6.5 million each year from the highways special revenue account to replace general fund in the Motor Vehicle Division). To provide a reference for legislators to illustrate the choices that would have to be made, Table 2 shows $50.6 million of reductions taken in the August 2002 special session that are included in the potential savings.

New Proposals and Other Initiatives

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

Table 2
Potential Savings - Special Session Actions
2005 Biennium

Item	Biennial Potential Adjustment
Motor Vehicle Division Fund Switch (HSSRA)	$13,081,502
Transfers to HSSRA	5,683,922
Hiring Freeze	2,800,000
Higher Ed 6 Mill Levy	419,824
Higher Ed Reductions	4,258,652
Public School Reductions	4,513,312
1 Percent Across the Board	7,770,612
Equipment/Supplies Reductions	6,834,188
Economic Development Reductions	5,220,000
Total	$50,582,012

ASSUMPTIONS USED IN PRESENT LAW PROJECTIONS

Present law projections include 2005 biennium fund balances at present law operations, which as stated are statutorily defined as the level necessary to continue existing services authorized by the previous legislature. Present law is used rather than actual fiscal 2002 expenditures in order to account for inflation and other costs, such as annualization of the state employee pay plan. It is also used because statute requires the executive to submit a present law budget, and the LFD to provide a present law analysis. Present law expenditures are at the levels established by the legislature in the 2001 session and as adjusted, where appropriate, in the August 2002 Special Session, with adjustments for caseload and enrollment increases. The present law projections do not include funding for increases in employee pay, the K-12 BASE aid funding schedules, or human services provider rates beyond the changes made by the 2001 legislature either in regular or special session. No funds are included for new programs, tax policy revisions, or legislative initiatives.

Revenues

Revenues included in the 2005 biennium projections are estimated collections under state and federal law and accounting procedures, with the rates and allocation percentages as specified under current law. The projected revenues for fiscal 2004 through 2005 contained in this report are preliminary estimates, based on fiscal 2002 actual collections and current economic trends. These revenue projections will be subject to more in-depth analysis and refined later in calendar 2002, as the Revenue and Taxation Committee undertakes its statutory duty to prepare a revenue estimate for presentation to the 2003 legislature.

Expenditures

Actual expenditures in fiscal 2002 are used as the starting point. Actual expenditures, minus one-time-only expenditures, were doubled to provide a base from which present law increases were calculated.[1] The following additional adjustments were made in projecting present law costs into the 2005 biennium:

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

- Personal services costs are at the level of FTE authorized by the 57th Legislature, with adjustments to reflect continuation of the 2003 biennium pay plan
- Anticipated enrollment changes in K-12 and the university system have been included
- Caseload and entitlement adjustments in human services and corrections programs (including Medicaid and prison population) anticipated under present law are included
- Budget modifications and miscellaneous ("cat and dog") appropriations enacted by the 57th Legislature are excluded if they were designated as one-time expenditures, while those funding ongoing duties are included in the present law projections
- Appropriations phased in during the 2003 biennium are funded for the entire biennium (e.g., pay plan and provider rate increases)
- Actions taken by the legislature in special session that are certain to continue, such as permanent changes in funding, are shown as a reduction in present law costs

Any budget reductions enacted for the 2003 biennium by the 2001 legislature in regular session are continued with the exception of vacancy savings. The vacancy savings contingency appropriated by the 2001 legislature to aid agencies unable to meet their personal services costs was not incorporated in the projected 2005 biennium Tables. The assessment of vacancy savings is considered to be a policy issue, and not a reflection of present law.

ADJUSTMENTS TO DERIVE PRESENT LAW

Table 1 shows the anticipated revenues and adjustments to the base budget to arrive at a present law budget. The major factors causing the changes as shown in the table are discussed below.

Revenues

General fund revenues of $2.594 billion for the 2005 biennium are anticipated to increase $53.5 million over the 2003 biennium, a growth rate of approximately 1 percent per year. Since the decline in individual and corporation income taxes were the primary revenue sources responsible for the current biennium budget deficit, the outlook for these two sources is critical in determining the fiscal status for the 2005 biennium.

Individual income tax is expected to increase by about 2 percent per year during the 2005 biennium while corporation income taxes are expected to be stable throughout the forecast period. Many of the smaller general fund revenue sources are expected to remain stable or trend up slightly during the 2005 biennium. This is very consistent with trends observed during last several years.

Expenditures

The projections for the 2005 biennium show that the costs of funding a present law budget would be a base budget of about $2.7 billion plus adjustments of $140.9 million, for total present law disbursements of over $2.8 billion. The major factors causing the $140.9 million in adjustments are summarized below.

2003 Biennium Supplemental Appropriations

The legislature included a $5.6 million supplemental appropriation reserve in the 2003 biennium ending fund balance (August 2002 Special Session). This Table includes $5.3 million for 2002 spring wildfire costs and $0.3 million for Department of Justice litigation costs. These supplemental costs are included in deriving the 2005 biennium projection calculation. In addition, the LFD projections include $6.2 million in additional anticipated supplemental requests. These additional supplemental appropriations reflect increased costs of providing present law services, and are costs that the executive has indicated will be included in the executive budget as supplemental requests. The additional $6.2 million includes:

1) An additional $0.6 million incurred costs for 2002 spring wildfire costs (submitted to the LFC in June);
2) $3.9 million for a Department of Public Health and Human Services (DPHHS) cost over-run submitted to the LFC in the June meeting as a transfer from fiscal 2003 to 2002 (the report also stated that the full amount would be requested as a supplemental in fiscal 2003. A plan for mitigation of the costs was not submitted); and
3) $1.2 million for payment of anticipated fiscal 2002 costs for fires that have already occurred, and $0.5 million for anticipated Spring 2003 fires.

Since no estimate is included in the 2003 biennium projected ending fund balance for the two additional projected supplemental appropriations, the final ending fund balance can be expected to be $6.2 million less if approved by the 2003 legislature, and therefore contributes to an increase in the projected 2005 biennium deficit.

It is emphasized that these supplemental projections are included because they are very likely to occur based on best available information, and the executive does not plan to mitigate these costs. There are additional areas with existing cost over-run projections in human services and corrections that may result in supplemental requests. These issues are not included in the projections but are discussed under "Significant Issues Not Included in 2005 Biennium Projections". Potential supplemental appropriations and cost over-runs are also discussed in more detail in a separate report entitled "Potential Agency Cost Over-runs/Supplemental Requests".

Public Schools

State public K-12 expenditures are expected to decline by $9.8 million during the 2005 biennium. This reduction is due to three major factors: 1) direct state aid and guaranteed tax base (GTB) aid for districts' general fund will decline by $15.0 million due to a projected decline in enrollment of 1.8 percent in fiscal 2004 and additional 1.9 percent in fiscal 2005; 2) state costs for GTB for county retirement funds will increase by $6.3 million during the biennium since fiscal 2002 (the base year) was low due to artificially high HB 124 block grants; and 3) House Bill 124 block grants will decline by $1.1 million relative to fiscal 2002 amounts. The fiscal 2002 amounts were artificially high because they were based on estimates of fiscal 2001 motor vehicle revenue given up by school districts under HB 124. As a result, HB 18, August 2002 special session, reduced the block grants to the appropriate level for fiscal 2003 and beyond.

Public Health

The $76.3 million general fund estimate for DPHHS present law budget costs was based on the initial $46.9 million budget submission to the Office of Budget and Program Planning, with two changes: 1) addition of $34.8 million general fund instead of state special revenue from a Medicaid provider assessment tax to support present law Medicaid costs; and 2) removal of a funding shift of $5.3 million to the general fund from the federal TANF (Temporary Assistance for Needy Families) block grant. These changes were made because both should be considered new proposals instead of present law funding according to statutory definitions.

The majority (77 percent) of the initial DPHHS request is to continue Medicaid services at present levels, which includes changes made to eligibility and service levels due to 17-7-140 and to mitigate the need for a supplemental appropriation. Including foster care, childcare, and supplemental security state payments, caseload and service changes comprise 85 percent ($64.5 million) of the present law request. Funding for state institution costs accounts for 8 percent ($5.9 million) and annualization of provider rate changes that are not included in caseload estimates accounts for 4 percent ($3.2 million).

The caseload estimates are reasonable given the data and trends at this point in time. Historically, caseload estimates have been revised in November and throughout the legislative session as more timely data is available.

Corrections

The increased present law cost of $11.1 million for fiscal 2004 and 2005 is based on:

- Adjusting fiscal 2003 projections for the new policy of conditional early release (the goal of conditional early release is to move 400 offenders from secure facilities to community corrections)
- A growth rate of approximately 6.0 percent in fiscal 2004 and 2005 in adult institutional populations each year above fiscal 2003 populations
- Continuation of the lower contract rate with contract bed providers (reductions made during the 17-7-140 cuts)
- Incorporating the DUI WATCh program projected savings in contract beds
- Status quo in juvenile corrections

Higher Education

Projected resident student enrollment for the Montana University System increases slightly less than 2 percent annually from fiscal 2002 actual levels based upon historical trends and early fall 2002 enrollment projections. Using the fiscal 2003 marginal general fund appropriation per resident student full-time equivalent of $1,914, the additional general fund cost due to the projected enrollment increase is $5.9 million in the 2005 biennium.

Projected resident student enrollment for the Community Colleges increases approximately 5.5 percent for the 2005 biennium from fiscal 2002 actual levels based upon historical trends and early fall 2002 enrollment projections. Using the fiscal 2003 general fund appropriation per resident student full-time equivalent of $2,792, the additional general fund cost due to the projected enrollment increase is $0.6 million in the 2005 biennium.

Pay Plan

The 2001 legislature appropriated $29.2 million general fund for the 2003 biennium pay plan, including $8.1 million in fiscal 2002[2]. Funding for the 2003 biennium pay plan was based upon delayed implementation in fiscal 2002, with a further increase in fiscal 2003. Because the legislature delayed the implementation of the salary and benefit increases (and because additional unfunded longevity costs will be built into the budget), personal services costs will increase even if salaries and benefits are frozen in the 2005 biennium. Total general fund costs are estimated to increase $36.4 million for the 2005 biennium over the doubled fiscal 2002 level.

District Court Assumption

Because the state did not assume the costs of district courts until fiscal 2003, fiscal 2002 contains no district court expenditures, and a full biennium cost ($38.9 million) must be added to present law. The fiscal 2003 appropriation in HB 18 (August 2002 Special Session) was inflated by 3.8 percent each year.

[2] Excluding contingency funds and funding for market adjustments.

Other Adjustments

This category includes the following adjustments ($8.975 million): 1) annualized costs from delayed implementation, including various university adjustments, new judges, and the dental hygiene program; 2) anticipated costs of implementation of broad-banding (an alternate personal services funding method) in several agencies; and 3) permanent changes made in the August 2002 Special Session. This category also includes funding for other present law changes in areas of state government not included in the other categories.

Statutory Appropriations

General fund statutory appropriations decrease $31.2 million from the base due primarily to the emergency appropriations, HB 124 appropriations, and property tax reimbursements. For the 2005 biennium, $8.0 million is estimated for emergency expenditures compared to the base amount of $26.4 million for emergencies/wildfires – a difference of $18.4 million. Appropriations to local governments under HB 124 are estimated to be $166.5 million for the 2005 biennium compared to a base of $177.9 million – a difference of $11.5 million mostly due to the state assuming district court costs beginning in fiscal 2003. Property tax reimbursements decline by $5.1 million according to a statutory formula. These decreases are mitigated by increases totaling $3.0 million in police and fire retirement payments.

Transfers

Transfers of money out of the general fund decrease from the base amount by $2.6 million. The difference is due primarily to: 1) a net decrease in HB 124 directed payments of $4.9 million, mostly because the transfer payment to fund district court expenses no longer occurs in the 2005 biennium; 2) a decrease in SB 495 payments of $4.1 million because principal payments in the 2005 biennium are less than interest payments in fiscal 2002; 3) a decrease in the transfer to the research and commercialization account directed by HB 5 of the August 2002 Special Session totaling $2.4 million; and 4) an increase of $9.2 million reflecting the implementation of HB 226 enacted by the 2001 legislature, that directs that a portion of U.S. mineral royalties be distributed to eligible counties.

SIGNIFICANT ISSUES NOT INCLUDED IN 2005 BIENNIUM PROJECTIONS

There are other issues with potential material impacts on the 2005 biennium budget for which the fiscal impact is either uncertain or unknown, and consequently are not included in the projections. Additionally, economic events could produce unanticipated changes in revenue projections. In the event that any of these become reality, there is a potential for impacts to the general fund balance. While not included in the fund balance projections, it is important that the potential impacts be considered in the legislative deliberations to balance the 2005 biennium budget. Each item is discussed briefly below.

Property Tax Reappraisal

The Department of Revenue (DOR) is responsible for the appraisal, assessment, and equalization of all property value in the state for the purpose of taxation. The current reappraisal cycle should be completed by the end of calendar 2002. The new values will be effective January 1, 2003 and will impact tax collections for fiscal 2004 and subsequent years.

If the new reappraisal values (excluding new property) increase by more than one-half of the average inflationary rate for the prior three years, then under the provisions of 15-10-420, MCA the statewide 40 and 55 mill levies are adjusted downward. This statute is designed to limit the amount of property taxes received by a governmental entity to the level of taxes assessed in the prior year plus an inflation adjustment as specified above.

The reappraisal values may also impact state Guaranteed Tax Base (GTB) aid. If some of the areas of the state that are relatively less wealthy have grown faster than more wealthy areas of the state, state GTB costs will decrease. Conversely, relatively faster growth in the wealthy areas of the state will result in higher state GTB costs. The amount of the change in state GTB aid will not be known until the new reappraisal data is made public.

TANF/CSED Services (Fund Switch)

Temporary Assistance for Needy Families (TANF) and Title XX - The utilization of the TANF fund balance and the increase in TANF caseload has severely reduced the funds available for transfer to other programs, including childcare and services to the developmentally disabled. In addition, Title XX funds used for services to the developmentally disabled continue to decline. Maintenance of these services could cost almost $28 million additional general fund over the biennium.

Child Support Enforcement Division - Replacement of reduced federal funds in the Child Support Enforcement Bureau to maintain current operations could total $1.6 million over the biennium.

The above items are not included as a present law adjustment since they would require a fund switch from federal funds to general fund, and would be a new general fund service. However, since it is an existing service, the legislature will likely be asked to consider continued funding.

Additional District Court Funding

In testimony to both the LFC and the Law and Justice Interim Committee, representatives of the Supreme Court identified several concerns with the current level of funding provided to administer and operate the district courts as directed in SB 176 (2001 regular session). Among the concerns were FTE that had been funded with grants, costs of the pay plan, and information technology and administrative costs. As of this writing, the 2005 budget request for the Judiciary had not been submitted, but the legislature could receive requests to fund significant increases for these and other items.

Other Potential Fiscal 2003 Supplemental Appropriations

In addition to the supplemental appropriations included in the 2005 biennium projections, based on current information, there are two other areas with potential cost over-runs that could result in fiscal 2003 supplemental requests. They include an additional $2.1 million in the Department of Public Health and Human Services and approximately $9.0 million in the Department of Corrections. The legislature should be aware of these potential over-runs, but understand that they are not included because the executive has the option to mitigate those cost over-runs by re-prioritizing or applying cost saving measures. The executive has not stated whether these cost over-runs will be mitigated. The $2.1 million in DPHHS is due to planned reductions that are contingent on receiving a Medicaid cost waiver from the federal government in fiscal 2003. It is unlikely the waiver will be approved in time to obtain the fiscal 2003 savings originally anticipated. Since the department has already had to make significant reductions both to stay within the fiscal 2002 budget and as part of fiscal 2003 reductions both by the legislature in special session and as directed by the Governor, it will be difficult to mitigate the over-run.

The $9.0 million cost over-run in corrections is due primarily to greater than anticipated prison population projections, but the executive plans to seek ways to reduce total prison populations. If this cost over-run cannot be fully mitigated, there is a strong likelihood of a supplemental request for the 2003 biennium.

These and other potential cost over-runs are discussed in more detail in a separate report presented to the LFC at the October meeting entitled "Potential Agency Cost Over-runs/Supplemental Requests".

Ballot Initiatives

The following are ballot measures that, if approved by voters in the November election, will have fiscal impacts.

Constitutional Amendments

1. C-36 is submitted to the voters by the legislature in Senate Bill 190. The amendment to the Montana Constitution would allow assets of local government self-insurance programs to be managed in the same way as they would be by a private insurance organization, including investing in private corporate stock. Stock investments would be limited to 25 percent of total invested assets. If approved, the amendment would be effective January 1, 2003.
2. C-39 is submitted to the voters by the legislature in Senate Bill 493. It would remove the restriction placed on the investment of public funds currently in the Montana Constitution that prohibits investing in private corporate capital stock. Currently, only public retirement system assets and assets in the state compensation insurance fund can be invested in private corporate capital stock. The amendment would require that the public school fund and the permanent funds of the Montana University System and all other state institutions of learning be invested in safe investments that a prudent expert acting in a fiduciary capacity would use in investing a fund guaranteed against loss or diversion. If approved, the amendment would be effective January 1, 2003.

Initiative Referendum

1. IR-117 is submitted to the voters through the initiative process and will determine the passage or rejection of HB 474 passed by the 2001 legislature. HB 474, among other things, changes provisions regarding the deregulation of the electricity industry. It:
    a. extends the transition to full customer choice of electricity providers to 2007;
    b. directs the Public Service Commission to set consumer rates to ensure full recovery of all prudently incurred costs by power suppliers;
    c. creates a public Montana Power Authority to construct, finance, and operate electrical facilities funded by state bonds; and
    d. creates, but does not fund, a consumer support program to ensure the availability of affordable power.

Initiatives

1. I-145 is submitted to the voters through the initiative process and would enact the "Montana Hydroelectric Security Act". It would create an elected public power commission to determine whether purchasing hydroelectric dams in Montana is in the public interest and would repeal the Montana Power Authority created by the 2001 legislature. The commission could negotiate to purchase the dams or, if necessary, use the power of condemnation to acquire the dams at fair market value. To pay for the dams, the state could issue $500 million in bonds to be repaid by the sale of generated electricity. Montana's small consumers would get priority to purchase the electricity. The commission could also invest in renewable energy and conservation projects. If approved, the act would be effective on passage and approval.
2. I-146 is submitted to the voters through the initiative process and would amend current statute and add new statutes concerning tobacco disease prevention and use of tobacco settlement funds. The Montana Constitution directs a minimum of 40 percent of tobacco settlement funds be deposited

to the tobacco settlement trust fund. Currently, 40 percent ($12.4 million in fiscal 2002) is deposited to the trust fund and the remaining 60 percent ($18.6 million in fiscal 2002) is deposited to the general fund. The initiative would direct 49 percent ($15.2 million) of the funds to state special revenue funds, leaving 11 percent ($3.4 million) for deposit to the general fund. Money in the state special revenue funds would be used for:

a. a statewide tobacco disease prevention program designed to discourage children from starting to smoke and to assist adults in quitting smoking ($9.9 million);
b. matching federal funds for the Children's Health Insurance Program and programs of the comprehensive health association ($5.3 million); and
c. the legislature would be required to appropriate from these accounts moneys to fund the newly created tobacco prevention advisory board.

If approved, the act would be effective on passage and approval and would apply to tobacco settlement funds received after June 30, 2003.

PHHS Lawsuit

The Montana Association of Independent Disability Services Inc. (MAIDS) recently filed a lawsuit alleging that the difference in the wage and benefit structure between community providers and state-run institutions has resulted in irreparable and unnecessary harm to the plaintiffs. In an article published in the Independent Record on September 19, 2002, Dave Eaton, president of the MAIDS association, estimated that $20 million is needed in order to make pay and benefits for workers in community-based programs equal to those provided employees of state-run institutions.

K-12 Funding Adequacy Lawsuit

In September of 2002, suit was filed in Montana's first judicial district court against the state of Montana alleging that the state has not adequately funded its K-12 school system. The plaintiffs are 11 school districts, the Montana Education Association, and seven parents. The plaintiffs seek the following remedies: 1) study and determine the components of free quality public elementary and secondary education; 2) study and determine the costs of delivering that quality education to all students in Montana, including costs that vary based on student or district characteristics; 3) implement a funding system that is based on educationally relevant factors and tailored to meet the costs of delivering a quality education; 4) fully fund, and equitably distribute the State's share of the cost of the public elementary and secondary school systems; 5) include a cost-adjustment factor in the funding system; 6) establish a mechanism for periodic monitoring of and adjustments to the funding system to assure it reflects current costs of delivering quality education, and to prevent a recurrence of the historical trends of declining state support and failure to keep pace with increasing costs; and 7) that the court retain jurisdiction for a period of time sufficient to assess whether the state has complied fully with the mandates of its declaratory and injunctive orders. This suit is unlikely to be decided in the 2005 biennium. However, if the plaintiffs prevailed, it could result in dramatically higher state funded education costs.

Personal Property Tax Rate Trigger

The tax rate on business equipment (class 8 property) will remain at 3 percent for tax year 2003. In tax year 2004, the tax rate may decline to 2 percent if prior year Montana wages and salaries as adjusted for inflation grow at a rate at least equal to 2.85 percent per year. If the wage and salary trigger is exceeded, the tax year 2005 tax rate would drop to 1 percent and would be zero in tax year 2006. In the last 20 years, growth in Montana wages and salaries adjusted for inflation have exceeded 2.85 percent five times, most recently in calendar 2000. Should this "trigger" be implemented, state revenues would decline an estimated $1.7 million in property taxes in fiscal 2004 and $6.2 million in fiscal 2005.

Economic Uncertainty and Revenue Trends

Since adjournment of the special session legislature, there have been numerous documents that depict the status of various national economic indicators. Although Dr. Paul Polzin of the Bureau of Business and Economic Research has indicated Montana's economy is doing well when compared to other states, it should be noted that state government revenues are not totally driven by employment and income levels. Montana revenues are extremely sensitive to many other factors such as corporate profitability, prevailing interest rates, capital gains/losses, and energy prices.

Corporate profits are well below the levels observed during the late 1990's even though interest rates are hovering at historical lows. The equity markets continue to be well below historic highs that mirror consumer sentiment about the US economy. Although oil prices have increased, higher prices do not necessarily equate to higher revenues. Because of higher prices, oil production revenues may increase but higher energy prices may also result in slower overall economic growth. These economic indicators, combined with current revenue trends, suggest that revenue growth could be less than projected in Table 1.

STRUCTURAL BALANCE

Structural balance refers to the matching of ongoing expenditures of government with ongoing revenues. If anticipated ongoing revenues equal or exceed expenditures, then structural balance is achieved. If expenditures exceed anticipated ongoing revenues, a structural imbalance occurs. The 2001 legislature approved a budget with a built-in structural imbalance of $57 million, due to using a one-time source of a high fund balance to fund ongoing expenditures. The dramatic decline in general fund revenues left fewer projected revenues to fund existing services, and the estimated structural imbalance grew to over $230 million prior to the August 2002 Special Session.

The projected 2005 biennium present law deficit in Table 1 shows an anticipated biennial revenue stream of $2.595 billion, as compared to projected total disbursements of $2.822 billion (excluding transfers), resulting in a structural imbalance in the 2005 biennium projections of $227 million. To the extent that the legislative budget resolves the shortfall with permanent budget reductions or permanent revenue increases, the structural imbalance will be reduced. To the extent that the budget shortfall is resolved with one-time reductions or revenue enhancements, the budget will remain imbalanced, and a permanent resolution of the shortfall will be deferred into the following biennium. This is an important consideration as the legislature adopts a budget solution in the 2003 legislative session.

CONCLUSION

The 58th Legislature faces the most severe budget crisis in at least 16 years, as the outlook for the 2005 biennium is for a shortfall of nearly 10 percent below the amount needed to fund a present law budget. The projected present law ending general fund balance for the 2005 biennium is a negative $226 million, and grows to a negative $249 million when allowing for a 2 percent ending fund balance reserve. In addition, there are a number of issues with potential material impacts on the 2005 biennium budget that are not included in the deficit projections. The majority of these issues would further exacerbate the deficit situation. With the economic uncertainties facing the state and the potential for further budget pressures, the deficit could grow to over $300 million. The deficit budget situation is the result of a sharp decline in general fund revenues, especially income tax collections, primarily due to a decline in the equity markets.

The legislature has in recent history had adequate funds to maintain present law services as well as to fund new initiatives each biennium. The severity of this deficit is demonstrated with the following comparisons:

- The deficit is larger than the 2003 biennium general fund operating budgets of all 24 agencies excluding the Departments of Public Health and Human Services, Corrections, and the education agencies (higher education and K-12)
- The deficit is as large as the combined operating budgets of the Department of Corrections and the Department of Justice
- Anticipated 2005 biennium revenues would not be sufficient to fund even a base budget, prior to funding the present law adjustments in Table 1.

The 58th Legislature will have to consider significant reprioritization of present law services, large increases in revenues, or a combination thereof in crafting the budget for the 2005 biennium.