# Managing Volatility, Part IV

## Updated Recommendations for Strengthening State Finances

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**LEGISLATIVE FISCAL DIVISION**
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LFD
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# Strengthening State Finances

This is fourth in a series of reports that outline the special set of tools and mechanisms Montana has developed to strengthen state finances. The state uses financial reserve tools to cushion the impact of state revenue collections volatility. When budget deficits are projected, statute defines how expenditure reductions and the budget stabilization reserve fund (BSRF) and fire fund may be used. Yet, when revenue collections far exceed estimates, plans for the unexpected revenue hit limitations and adjustments to those limitations may be reasonable. Incorporating well-designed fiscal rules and targets strengthen the state's reserves and improve the state's financial position.

Montana's volatility toolbox includes the following:

- a structurally balanced budget (ongoing revenues are sufficient for ongoing expenditures)
- a suggested operating reserve of general fund for liquidity management
- executive statutory parameters for budget management including expenditure reductions in times of need
- Governor's emergency statutory appropriation
- dedicated reserve funds for budget stabilization (BSRF), wildfire suppression, and capital development

**Managing Volatility Part IV: Takeaways**

1. Montana's revenue volatility is high and rising, largely due to reliance on income tax
2. Montana currently has very high reserve balances, mostly due to short-term revenue growth
3. Policymakers may wish to consider changes to the BSRF, fire fund, and other tools to further safeguard state finances against future revenue shortfalls

In June 2022, The Pew Charitable Trusts published *State Tax Revenue Volatility and Its Impact on State Governments*. This report commissioned by the Pew Charitable Trusts explains that "by analyzing and quantifying tax revenue volatility, policymakers and their advisors can better anticipate and manage its effects and understand how policy changes might reduce volatility."[1] Although the Legislative Fiscal Division analyzed and quantified revenue volatility in previous reports, the Pew report served as a reminder that recent uncertainty in the global economy, including continued coronavirus instability, inflation, and wage growth causes tax revenue volatility.

The previous three reports from the Legislative Fiscal Division focused on the following: 1) best practices in other states; 2) comprehensive systems to manage financial volatility; and 3) statistical analysis to predict long-term trends and evidence-based recommendations to strengthen state finances.

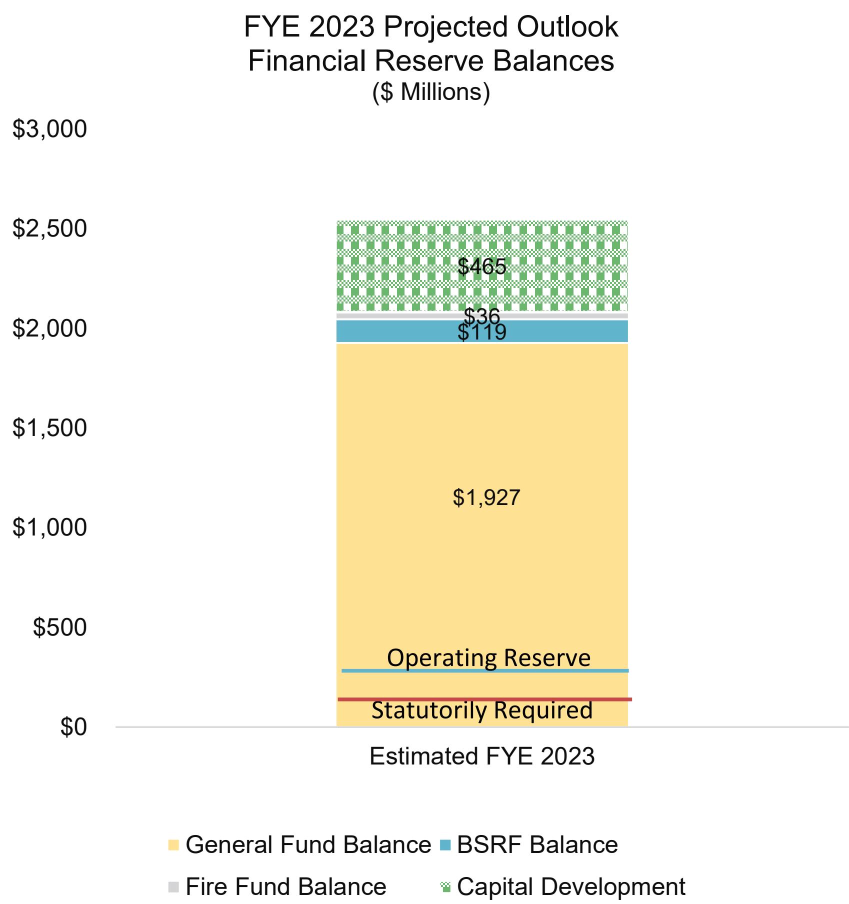
This report provides updated statistical calculations and options to consider for adjustments to the following financial management tools:

1. General Fund Operating Reserve for Liquidity Management (17-7-102(11), MCA)
2. Budget Stabilization Reserve Fund (BSRF) Functions (17-7-130, MCA)
3. Governor's Emergency Statutory Appropriation Options (10-3-312, MCA)
4. Wildfire Suppression Fund (76-13-150, MCA)

[1] State Tax Revenue Volatility and Its Impact on State Governments, Don Boyd, SUNY Albany. June 30, 2022, Commissioned by the Pew Charitable Trusts, pg. 4.

# State Financial Reserve Balances, Current Law

As mentioned above, the state relies on financial reserve balances in times of economic volatility. Since revenue collections in FY 2021 and FY 2022 were exceptionally high, the state financial reserves benefited from the short-term surge in revenues. The general fund balance for FY 2023 is projected to be nearly $1.7 billion above the operating reserve for liquidity management. This large balance is primarily the result of the "bubble" or short-term revenues.




In addition to the general fund, financial management tools like the budget stabilization reserve fund (BSRF) and a working capital development revenue fund (CD) received an influx from high revenue collections. The BSRF reached its limit, as defined in statute (4.5% of the total general fund appropriation in the second year of the biennium) and had a full balance of $118.9 million at the beginning of FY 2023.

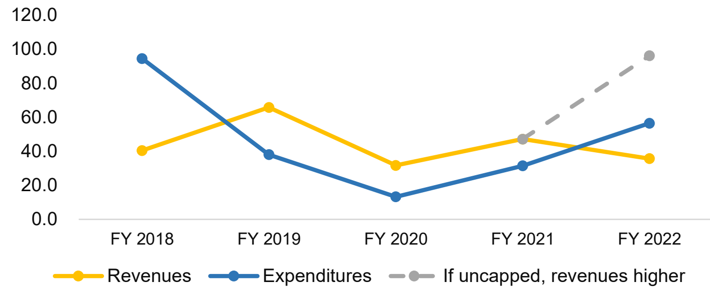
When the BSRF is statutorily full, a portion of excess general fund revenues flow to the CD fund where it is available for appropriation for major repairs and improvements to state-owned infrastructure. Since the BSRF was full, the CD fund received $259.7 million in FY 2022 from excess general fund revenues. The CD fund is projected to have an ending fund balance of $465.4 million at the end of FY 2023.

The wildfire suppression fund is also available to the legislature as a reserve fund for use in times of financial need. Per statute, the balance of the wildfire suppression fund is limited to 4.0% of the total general fund appropriation in the second year of the biennium. However, the average cost of wildfire suppression has increased in the last ten years from $22.3 million per year to $29.2 million per year. Based on cost estimates for FY 2023 and projected revenues, the fire fund balance is estimated to be $36.0 million by the end of FY 2023.

# Expenditure Risk and Volatility

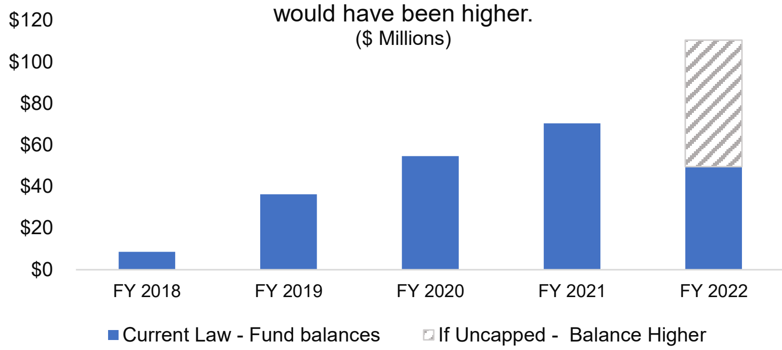
The LFD examined the wildfire suppression fund statute limitations for transfers into the fund based on unspent general fund authority. In FY 2022, if the limitation of 4.0% of total general fund appropriations in the second year of the biennium had been removed, additional funding would have been available.

Fire fund revenues and expenditures are volatile. In FY 2022, if the fire fund had not been capped, additional funding would have been available.
($ Millions)




Under current statue, the fire fund balance is projected to erode. The following graph shows the fire fund balance from FY 2018 – FY 2022 and what the FY 2022 balance might have been if the fire fund had not been limited by statute.

Shown are fire fund balances FY 2018-FY 2022. If the fire fund had not been capped, the FY 2022 fund balance would have been higher.
($ Millions)




Since 2001, the Governor's emergency statutory appropriation authority has been $16.0 million per biennium. In the past the fund has been used for floods, fires, and other declared emergencies. Current statute allows the unspent portion of the emergency appropriation to be transferred to the fire fund at the end of the biennium. The $16.0 million has not been adjusted for inflation since 2001. If the emergency statutory appropriation was adjusted for inflation to FY 2025, the $16.0 million cap would be $28.3 million. If statute included biennial inflationary adjustments this could mitigate future emergency costs and provide a reliable source for the fire fund at the end each biennium.

# Revenue Risk and Volatility

The LFD updated the statistical analysis used to predict the frequency and magnitude of revenue downturns in the state economy. The patterns governing these economic upturns and downturns help predict future frequencies and severities, and this report includes options to consider for the level of response needed.

Increased volatility in state revenue collections moving forward is likely as individual income tax continues to grow relative to other general fund sources. The June 2022 Pew report mentioned above studied the characteristics of the most volatile states in revenue collection from 2000 – 2020 and found that Montana ranked 10th most volatile due to the state's disproportionate reliance on individual income tax.[2] In addition, the report further stated that "even in mild recessions, large

[2] Ibid, pg. 52.

income tax declines were associated with large capital gains declines”[3]. Capital gains income constituted nearly 10.0% of Montana’s individual income in CY 2020.

The following table shows the top ten general fund revenue sources (measured as the average collections from FY 2002 through FY 2021 in 2022 dollars). These ten general fund sources account for over 90.0% of total general fund revenue. Furthermore, it ranks the volatility of each source compared to the top ten sources based upon the median year-to-year change in real terms. Finally, the last column displays the range of the largest decrease to the largest increase from one year to the next.

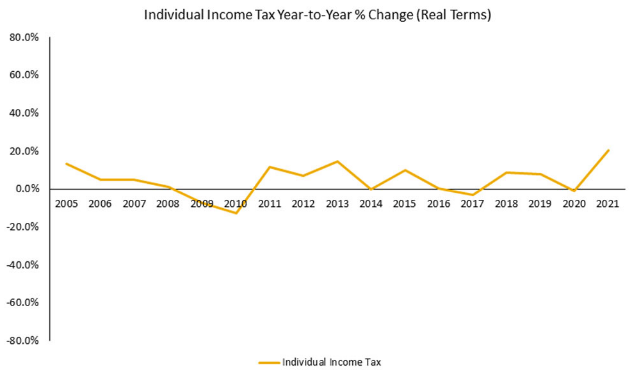
($ Millions 2022 Dollars)

| General Fund Source | Average Collections | Ranking | Median % Change | Year-to-Year Range |
|---|---|---|---|---|
| Individual Income Tax | $1,138,331,701 | 3 | 7.24% | (-$127.9, $297.3) |
| Property Tax | $270,344,085 | 9 | 2.33% | (-$10.1, $15.2) |
| Corporate Income Tax | $164,551,517 | 1 | 21.97% | (-$97.2, $74.9) |
| Vehicle Taxes & Fees | $129,120,566 | 10 | 2.26% | (-$11.5, $12.0) |
| Oil & Natural Gas Taxes | $85,597,623 | 2 | 16.39% | (-$63.3, $62.3) |
| Insurance Tax | $75,225,381 | 7 | 3.33% | (-$18.2, $6.5) |
| Video Gaming Tax | $68,035,202 | 8 | 3.19% | (-$13.0, $16.2) |
| Cigarette Tax | $35,178,651 | 6 | 4.01% | (-$3.7, $1.4) |
| Coal Trust Interest Earnings | $32,498,116 | 5 | 6.20% | (-$9.3, $3.2) |
| U.S. Mineral Leasing | $31,049,776 | 4 | 7.52% | (-$11.5, $8.9) |

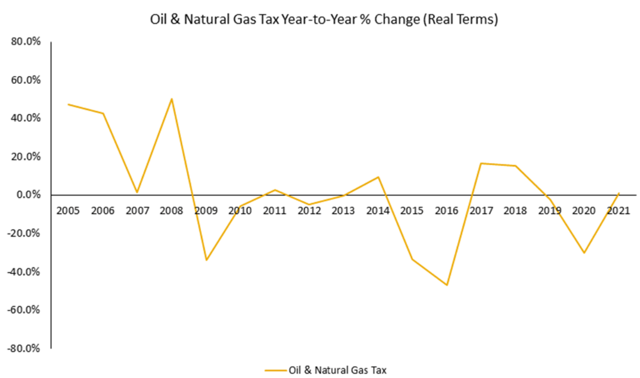
As the table above shows, corporate income tax, oil and natural gas taxes, and individual income tax are the first, second, and third most volatile sources out of the top ten general fund sources. Since individual income tax is the largest, it is no surprise that its range of changes from one year to the next is the largest, even though both corporate income tax and oil and natural gas taxes are more volatile. In inflation adjusted dollars, individual income tax has experienced a year-over-year decline of $127.9 million as well as a year-over-year increase of $297.3 million, representing a range of $425.2 million. While not as large, corporate income tax has experienced a range of $172.1 million and oil and natural gas taxes have experienced a range of $125.6 million.

[3] Ibid, pg. 5.

The following graphs further illustrate the volatility of individual income taxes, corporate income taxes, oil and natural gas taxes, and property taxes.

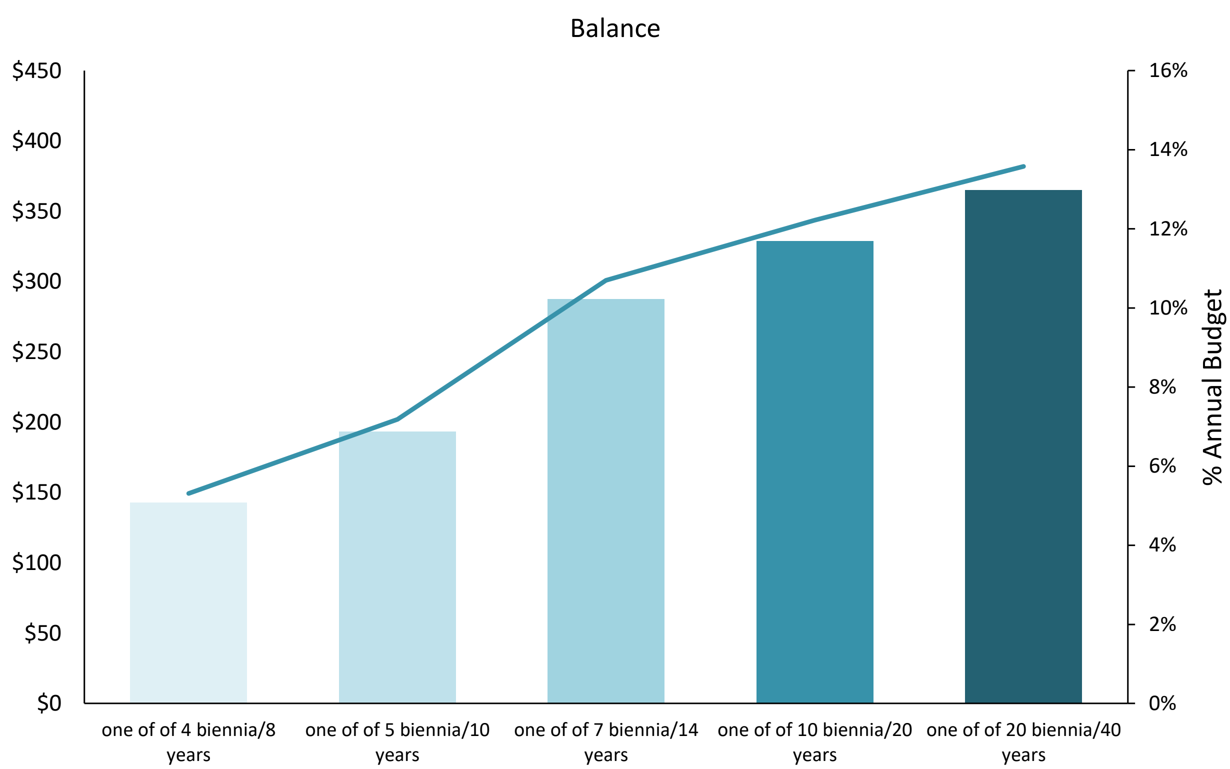








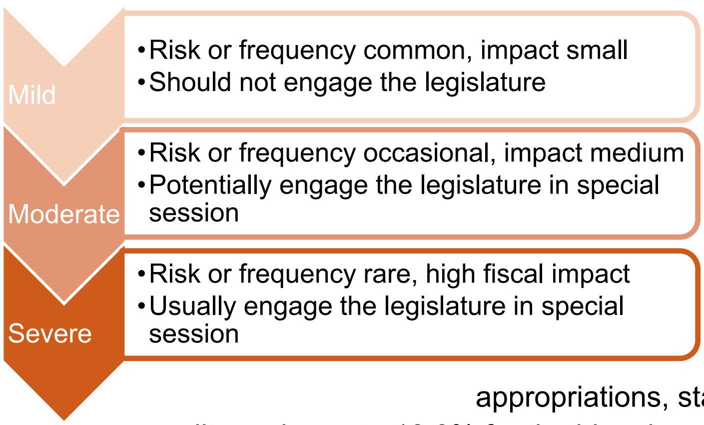
The following graphic, updated from the 2018 report, shows the frequency that various levels of revenue shortfall occur: higher levels of revenue "shock" occur less frequently. A policy of "scalable response" under various levels of risk is appropriate. Tools to respond to shortfalls should match the level of severity of the shortfall with more tools needed for the legislature and the executive to respond to large scale shortfalls.



When shortfalls in revenue collections occur, legislators should consider the “breaking point” for legislative involvement versus permitting the executive to cope with fiscal problems with the existing financial tools. For example, consider the leftmost column in the chart above: a revenue shortfall of about 5.3% of the annual general fund budget. In this scenario it may be prudent to permit the executive to manage this shortfall with certain tools rather than require legislative involvement. In contrast, consider the rightmost column in the chart above: a shortfall of about 13.0% of the annual general fund budget, which is expected to occur in about one out of every 20 biennia. This type of shortfall would likely be tied to a broad macroeconomic contraction and the Legislature would likely wish to be involved in responding to a contraction of this magnitude. Additionally, it is probable that a contraction of this size would lead to federal action of some type, including intergovernmental transfers to states, as experienced during the Great Recession and the COVID era. At some point in between the leftmost and rightmost columns is a level of shortfall which could be considered the ideal “tipping point” for legislative involvement in managing a revenue shortfall. The ideal “tipping point” will vary depending on circumstances.

## Shortfall Response Under Current Law

Assuming the budget is structurally balanced (ongoing revenues higher than ongoing expenditures), under current law, Montana has a scalable response to revenue shortfalls. The balance in responsibilities between the Governor and the Legislature is different at each level of shortfall.




<u>Mild Occurs 1 in 5 biennia:</u> If revenues experience a mild shortfall, the Governor has readily available access to the recommended minimum of 4.3% of general fund operating reserve to absorb minor revenue shortfalls.

<u>Moderate Occurs 1 in 7 or 1 in 10 biennia:</u> If the shortfall is greater than the operating reserve cushion, and the general fund balance drops below 4.0% of second year appropriations, statute allows the Governor to cut certain expenditures by up to 10.0% for the biennium and use funds in the BSRF at a ratio of $2 of BSRF for every $1 of expenditure reduction. If the BSRF is completely depleted, then the Governor may use available wildfire suppression funds at a ratio of $1 of wildfire suppression funds for each $1 of expenditure reductions. In addition, the capital development fund which receives an annual infrastructure investment of 1.0% state general fund revenue could be temporarily reduced. The fund serves as a working rainy-day fund, with the intention to pay for state infrastructure needs but in times of need, the fund may be used to mitigate economic volatility.

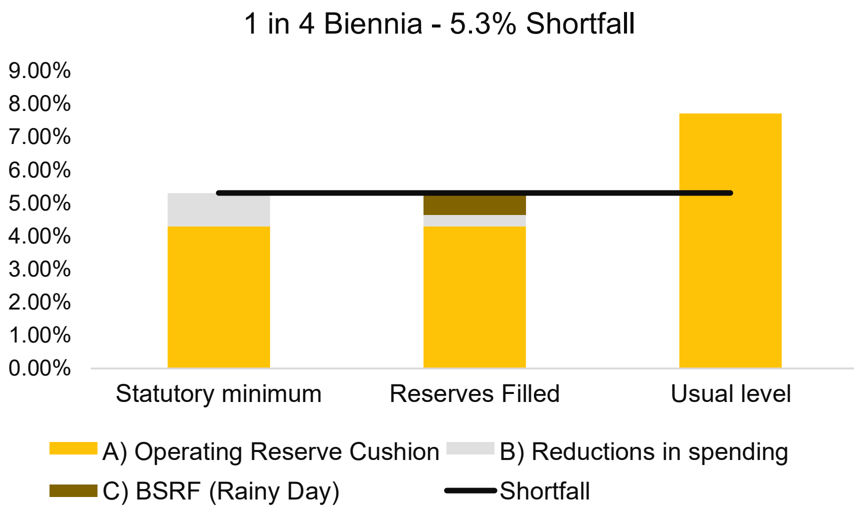
<u>Severe Occurs 1 in 20 biennia:</u> If the Governor cannot reduce spending under current statute enough to rebalance the ending fund balance back up to the statutorily required 4.0% of second year appropriations, then the Governor may call a special session and engage the legislature in decision making.

# Options/Scenarios to Consider

### Mild Shortfall: General Fund Operating Reserve

Shortfalls of 5.3% that occur one in four biennia usually may be addressed by the executive without involvement of the legislature. The executive has immediate access to the general fund operating reserve or cash buffer to use for mild shortfalls. The cash buffer or operating reserve represents 4.3% of second year general fund appropriations.

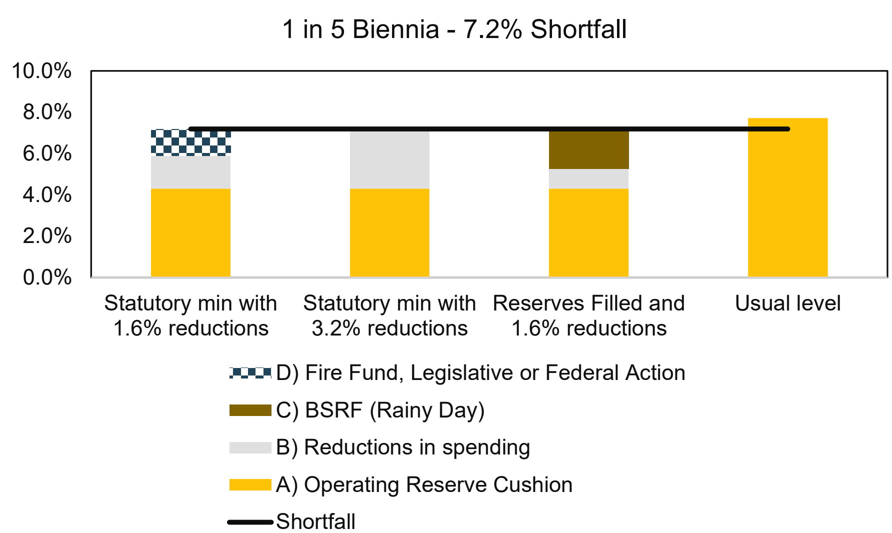
The adjacent graphic shows what options are available if a 5.3% shortfall occurs. The statutory minimum column demonstrates what may happen if the executive uses the operating reserve of 4.3%, then the executive may also need to reduce expenditures by 1.0% to meet a 5.3% shortfall. However, if the reserves are full, then executive has the option to use 0.7% of the BSRF and reduce expenditures by 0.3%, which is less impactful on executive agency budgets. The usual level represents a "normal" or "usual" situation for state finances. The usual level represents the average actual balance in recent years, which has been higher than the general fund statutorily operating reserve of 4.3%. See option 1 on page 10.



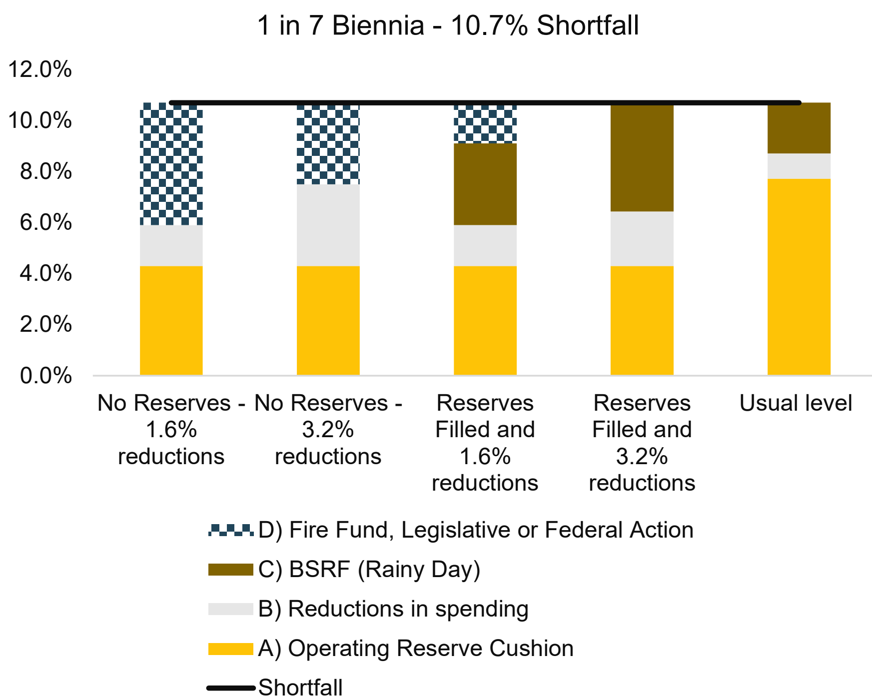

## Moderate Shortfall: Operating Reserve, Budget Stabilization Reserve Fund, Agency Budget Reductions, Fire Fund and Other Action

When moderate shortfalls of 7.2% or 10.7% occur, more financial volatility tools are needed. When a one-in-five biennia shortfall of 7.2% in revenue occurs, the operating reserve, reductions in agency budget expenditures, use of the BSRF, and possible fire fund use may be needed. When a 10.7% shortfall is experienced, a mixture of state financial tools and possible legislative action may be needed.

As demonstrated in the adjacent graphic, when a budget deficit is projected, current statute authorizes the executive to utilize the BSRF and reduce general fund budgets up to 10.0% of general fund or 4.0% of all funds for the biennium. Yet in practice, it is difficult to reduce more than about 1.6% per year. If reserves are full, the BSRF may be utilized to mitigate expenditure reductions, resulting in the use of 1.9% BSRF, 1.0% spending reductions, and 4.3% operating reserve. If reserves are not full, other options might be needed, such as accessing the fire fund or increasing the level of agency budget reductions.

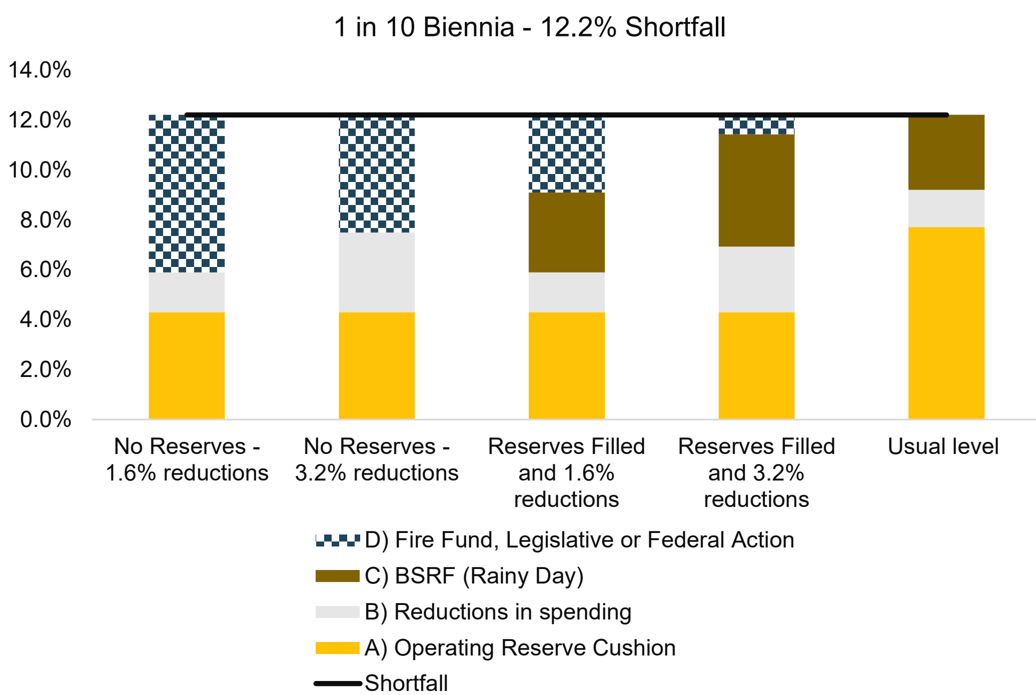


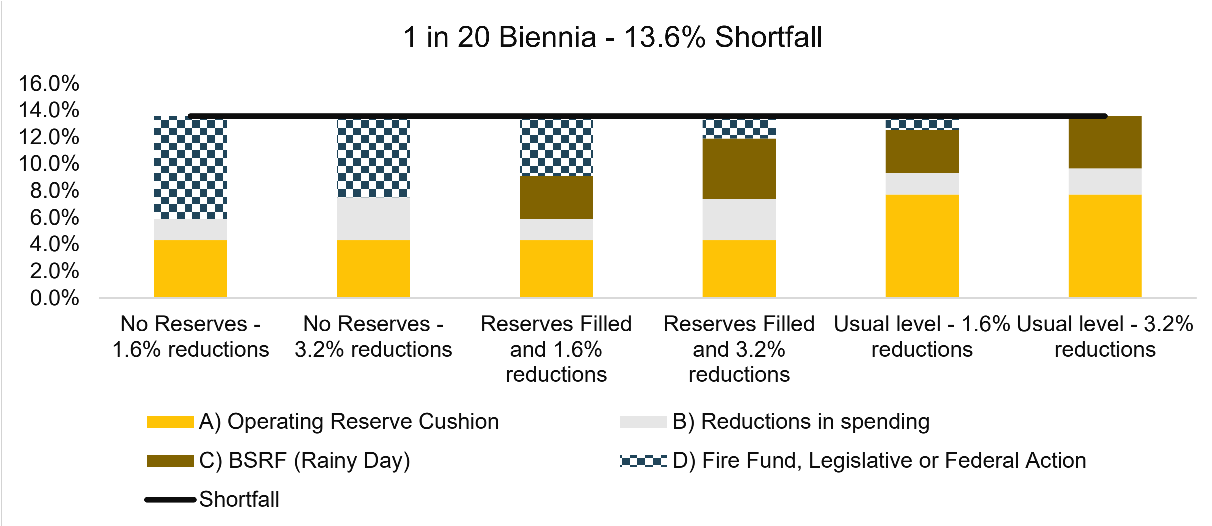

The following graphic demonstrates the options when a 10.7% revenue shortfall occurs.




## Severe Shortfall: Special Session

If severe shortfalls of 12.2% or 13.6% occur, the executive and the legislature will likely need to work together to address the situation. The two graphs on the following page illustrate options for the reserves, reductions in spending, and other action.






# Options to Consider/Conclusion

As discussed earlier, individual income tax is Montana's third most volatile source out of the state's top ten general fund sources (90.0% of collections). Individual income tax collections historically represented swings from a reduction of $127.9 million to an increase of $297.3 million in a year-to-year change. In FY 2021 and FY 2022, state revenue collections were at unprecedented levels. Investing short-term or "bubble" revenues in assets or financial tools for future state budgets may be prudent given high and rising volatility.

The legislature may wish to consider the following options:

1) Increasing the size of the operating reserve cash buffer from 4.3% to 5.3% to provide additional cash reserves for mild shortfalls that occur about one in every four biennia
2) Increasing the cap on the BSRF – the BSRF is currently capped at 4.5% of the total general fund appropriation in the second year of the biennium (about $118.9 million)
3) If the BSRF cap is increased, the legislature may wish to limit the access of the executive to this fund. For example, if the fund is above 4.5% of total general fund appropriations, then the Governor could have access to half the amount above 4.5%.
4) Increasing the cap on the fire fund to allow more revenues to flow into the fund
5) Providing inflationary adjustment for the Governor's emergency statutory appropriation to bring authority up to $28.3 million rather than the current $16.0 million, then adding a biennial inflationary adjustment thereafter. This change would permit the emergency appropriation to adjust for inflation and would provide the executive with additional flexibility to respond to floods, fires, and other emergencies

Keep in mind that in the event of a large shortfall federal action is very possible – it is likely that a national macroeconomic contraction has also occurred, and the federal government has demonstrated a high likelihood of responding to such a contraction with some type of fiscal relief to state and municipal governments.