LEGISLATIVE BUDGET ANALYSIS
2013 BIENNIUM
VOLUME 1 – STATEWIDE PERSPECTIVES

REPORT FROM THE LEGISLATIVE FISCAL DIVISION
TO THE SIXTY-SECOND LEGISLATURE

January 2011

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Acknowledgements

The multi-volume *Legislative Budget Analysis* report is the product of many hours of analysis by the staff of the Legislative Fiscal Division (LFD), a nonpartisan office which provides fiscal and policy information and advice to the legislature. The LFD thanks the many entities that assisted in its completion, particularly the Print Services Bureau.

LFD Publications

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December 2010

Members of the Sixty-second Legislature:

I submit for your consideration the state budget outlook for the 2013 biennium and the analysis of the Governor's Budget in volumes 1 through 8. They are available online at the following link: http://leg.mt.gov/css/fiscal/reports/2011-session.asp. The work contained in these volumes of analysis began a year ago when the Fiscal Division began its analysis for a March 2010 mid-interim budget update for the Legislature and the Legislative Finance Committee.

Since that March update, the Legislative Finance Committee has worked to create options for the 2011 session through a number of efforts:

- Directed staff to create budget options for the Reference Book and available online at: http://www.leg.mt.gov/css/Committees/Administration/Finance/2011_lfc_default.asp
- Reviewed and heard public comment regarding items in the Reference Book with many full interim committees and subcommittees of the same.
- Adopted recommended motions for joint appropriation subcommittee to give additional choices presented by the executive.

As a result of this work many more options will be available to the 2011 session than would have been available with just the work of the executive. Some of this work has generated bills that will be considered through legislative deliberation.

My first year as the Legislative Fiscal Analyst has been an honor and a privilege. The Montana Legislature, being a citizen legislature, not only represents the people of Montana; they are the people of Montana. I want to thank the members of the Legislative Finance Committee for their wisdom and guidance that got me through the challenges of this past year.

I also need to thank the staff of the Legislative Fiscal Division. These professionals are solidly committed to the Legislature and to serving the people of Montana. They are an amazing group that works hard to find the answers for your fiscal concerns. You will find them listed with their areas of expertise on pages ix.

Finally, I need to thank the agency staff and Office of Budget and Program Planning for their cooperation and assistance in creating this analysis.

Sincerely,

Amy Carlson
Legislative Fiscal Analyst

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INTRODUCTION VOLUME 1

PURPOSE OF VOLUME 1

The purpose of this report is to provide legislators with the information needed to assist them in crafting a balanced state budget and fiscal policy, and in reflecting their priorities in the 2013 biennium general appropriations act and other appropriations bills. It seeks to accomplish this by: 1) providing perspectives on the state's fiscal condition and the budget proposed by the Governor for the 2013 biennium, and 2) identifying some of the major issues now facing the Legislature. As such, this document is intended to complement Volumes 2 through 7 of the Legislative Budget Analysis – 2013 Biennium, which contains our review of the 2013 Biennium Executive Budget. In addition, this document is a reference document for all legislators, providing a myriad of information about state government.

While Volumes 2 through 7 of the Legislative Budget Analysis report the results of our detailed examination of revenue estimates and expenditures and proposed budgets of state programs, Volume 1 presents a broader fiscal overview and discusses significant fiscal and policy issues which either cut across program or agency lines, or do not necessarily fall under the jurisdiction of a single fiscal subcommittee of the legislature. Volume 1 discussions incorporate the December 15 Governor's revisions.

This volume is divided into six parts:

- **2013 Biennium Overview** provides a high level summary of our analysis of the proposed executive budget.
- **Perspectives on the Economy and Demographics** describes the current outlook for the economy.
- **State Revenues Perspectives** provides a review of the revenue projections in the budget and our own assessment of revenues through FY 2013.
- **State Expenditures Perspectives** – Part One provides an overview of the state spending plan for the 2013 biennium.
- **State Expenditures Perspectives** – Part Two evaluates the major expenditure proposals in the budget.
- **Major Issues Facing the Legislature** includes discussions of several issues, a list of which can be found on page 92 of this volume.
- **Agency Summaries** provides a budget comparison table, an organizational chart, and major highlights of each agency budget.

WHAT IS CONTAINED IN VOLUMES 2 THROUGH 7?

Volume 2

Volume 2 includes a summary and overview of the state's major revenue sources. A review of the table of contents will give the reader a quick idea of revenue sources included and the structure of the report. This volume will be provided to the House and Senate Taxation committees for use as a working document, and delineates the economic assumptions used to derive revenue estimates adopted by the Revenue and Taxation Interim Committee (RTIC) on November 19, 2010 and introduced in the revenue estimate bill (HJR 2).

Volumes 3 through 7

Volumes 3 through 7 offer detailed analyses of individual agency budgets, as proposed through the Governor's Executive Budget submitted in mid-November, but had gone to print before the December 15 revisions were received. These volumes feature program-by-program detail, as well as the LFD analysis of each agency budget. Agency presentations are grouped in sections corresponding to the appropriations subcommittee addressing the agency.

- Volume 3 contains section A – General Government
- Volume 4 contains section B – Health and Human Services
- Volume 5 contains section C – Natural Resources and Transportation
- Volume 6 contains section D – Judicial Branch, Law Enforcement, and Justice
- Volume 7 contains section E and F – Education and Long-Range Planning, respectively

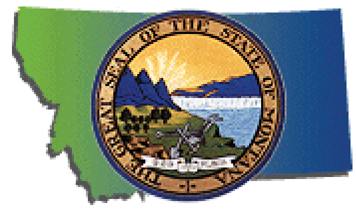
Volumes 3 through 7 briefly describe the agencies from all three branches of state government, as well as each program within an agency. The basic structure used for the analysis is consistent across agencies. These volumes detail an agency's requests, as well as a list of proposals and issues significant to the agency. When appropriate, there may be discussion of circumstances that could hold budgetary impacts (e.g., proposed executive legislation or agency reorganization). These volumes also present detailed discussions of present law adjustments, new proposals, and significant issues facing the various agencies as identified by legislative fiscal analysts.

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

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

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

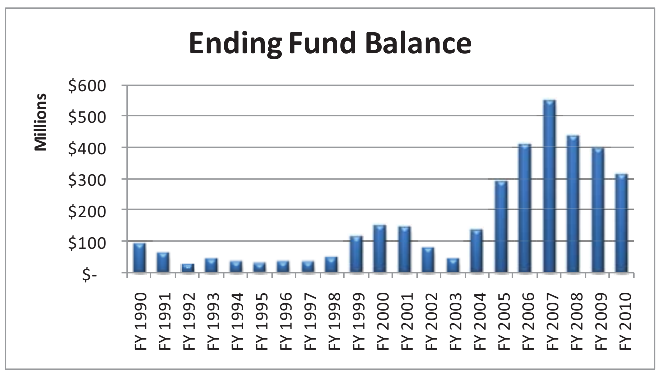
Budget Overview
-An Executive Summary –



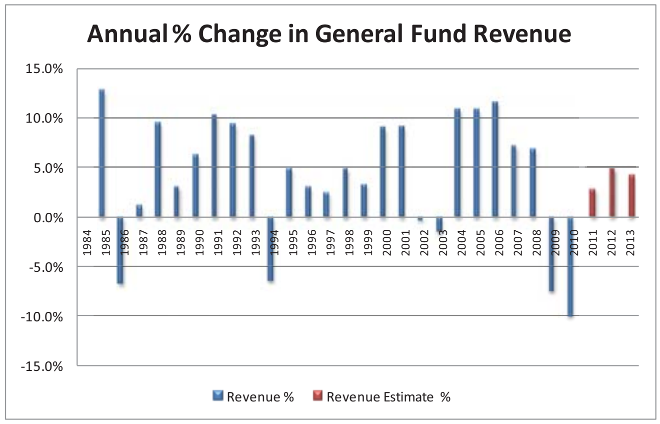
SETTING THE STAGE

Up until the last year or so, it appeared that the revenue impact to Montana of the recession would be mild. Significant revenue declines in Montana were not fully realized until late in 2009. Most states experienced the full impact of the Great Recession earlier.

In addition to the delayed revenue impact going into the recession, Montana was in an unusually strong fiscal position just prior to the recession. General fund ending balances were at record high levels, and then in FY 2010 and FY 2011 federal stimulus funds boosted the state economy and shored up state spending.



Also contributing to the strength of Montana's fiscal position was five years of above average revenue growth. Revenues increased in excess of 10% per year in FY 2004, FY 2005, and FY 2006



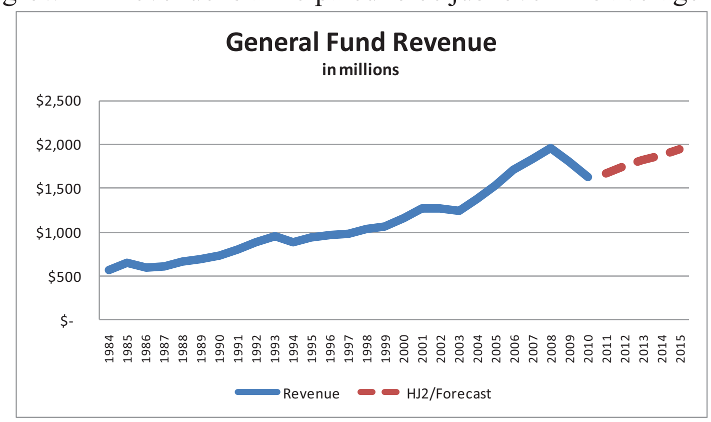
While growth slowed in FY 2007 and FY 2008, it still remained above average.

FY 2009 and FY 2010 revenue declines were larger than had been observed for decades. Projected revenues during the 2009 legislative session were reduced in anticipation of the recession reaching Montana. However, the downturn in revenues was sharper than anticipated. The graph on the top of the following page shows the unprecedented declines.

National economic forecasts show the downturn in the economy is over and a slow recovery will follow in the coming years both for Montana and the rest of the nation. State revenue collections lag behind the state economy, both as the economy slows and as it recovers. As the economy recovers, the recovery in state general fund revenues tends to be 12 to 18 months after that point.

Revenue growth can be robust after some recessions in the years following FY 2002 and FY 2003 growth exceeded 10% per year. Other recoveries have slower growth, as the shown from FY 1995 to FY 1999.

Overall average growth in the general fund revenue has been 4% since 1984. The growth in revenue is anticipated to be just over this average in FY 2012 and FY 2013.



While ongoing spending was never committed at the high level of revenues received in the mid-2000s, current levels of ongoing spending are higher than the forecast level of revenue for the next two biennia.

Legislative Reaction

In early 2010, it was clear that FY 2010 revenues would be far below anticipated levels, and that Montana's spending levels would be inconsistent with long term revenues. At about the same time, an article had just been published by The National Governors Association Center for Best Practices titled "The Big Reset, State Government After the Great Recession". The article captured the essence of the problem Montana and other states face in "right sizing" their spending. From that point, the Legislative Finance Committee proceeded to engage the Legislative Fiscal Division (LFD), other interim committees, and constituents in generating and evaluating ideas to reduce spending and/or increase revenues. These ideas were set forth in a "Reference Book" to help to create a framework for session action to be effective at getting to the heart of the financial issues at hand. The challenge facing the legislature is large, but resources for getting the work done are available.

OVERVIEW

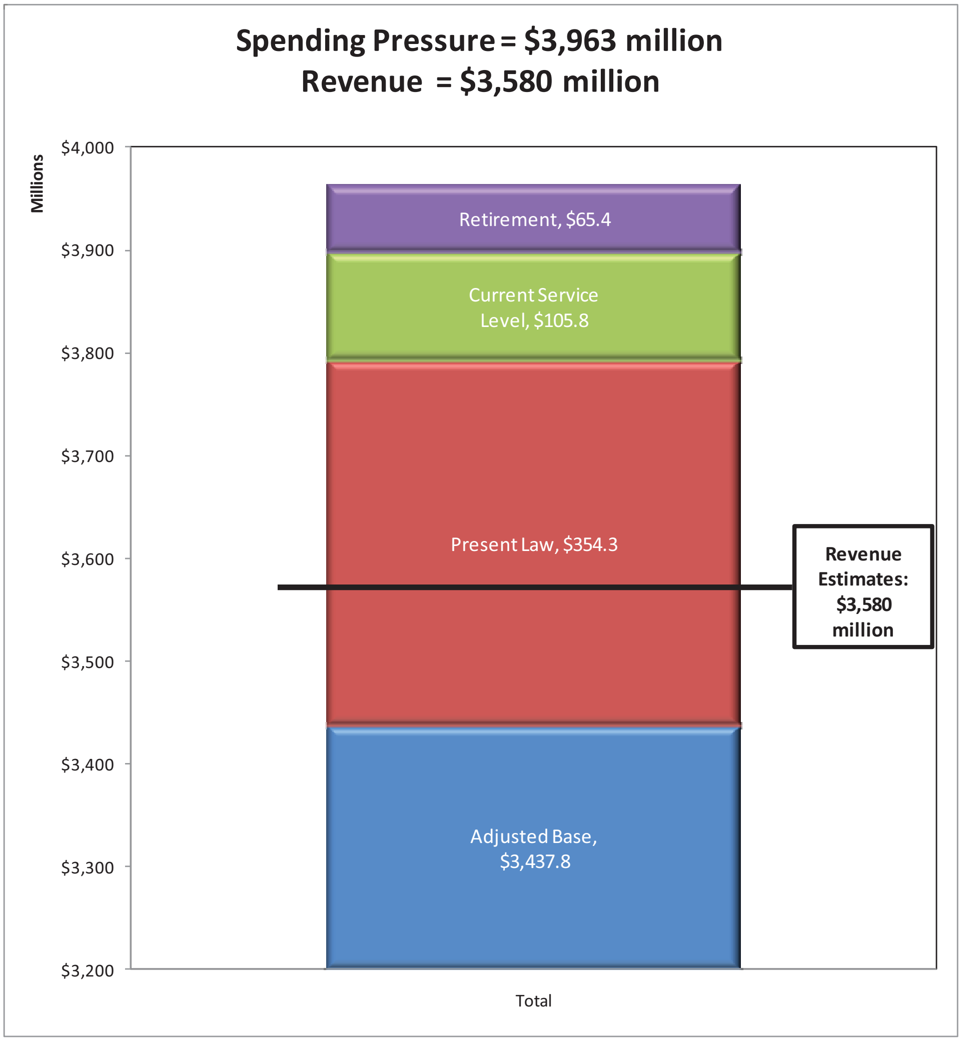
This budget overview is intended to highlight the major budget pressures and challenges facing the legislature, describe the method the Governor chose to resolve these challenges, and give an overview of the legislative work to date for options to resolve the budget pressures. The following outlines the topics:

- Financial Condition of the General Fund: Reviews the overall condition and budget pressures in the state general fund and defines the budget gap
- Legislative Preparation for Closing the Budget Gap: The work of the Legislative Finance Committee in preparing to give options to the 2011 Legislature
- Budget Recommendations of the Governor
- Gap Closing Recommendations of the Governor: How the Governor has chosen to resolve the funding issues
- Governor's Budget Updated with legislative revenue estimates HJ 2 and K-12
- Governor's Budget Policy Questions
- Caution on Revenue Estimates

THE FINANCIAL CONDITION OF THE GENERAL FUND

As required by state law, the Governor proposed a solution to balance the budget. While the public and others have expressed concerns with specific proposals, understanding the underlying financial conditions sheds light on why such proposals may have been chosen and what obstacles the legislature faces in balancing the 2013 biennial budget.

The following updates the analysis the Legislative Fiscal Division presented in March and September on the overall general fund state financial and budget condition for the 2013 biennium. The updated analysis shows that the underlying budget gap between ongoing revenues and ongoing spending pressures persists. This gap includes different categories of costs with varying degrees of spending pressure: adjusted base, present law, the level of current services provided, and the cost to pay the actuarial-required rate for the retirement systems (see the page 5 for terms and definitions). All of these components of cost add to ongoing fiscal pressure in the state general fund and other state funds. Due to the wide reaching nature of the state general fund, it is the focus of this analysis.



The changes in forecasted revenues, retirement costs, and the Governor's reductions to the "adjusted base" narrowed the gap, but updated cost estimates in two of the largest cost areas: K-12 schools and Department of Public Health and Human Services, have increased costs. If all categories of cost continue to be measured, the structural budget gap is now approximately $383 million ($3,963 million less $3,580 million) in comparison to the just under $400 million projected in March and $368 million in September.

The Governor's budget proposes one solution to closing the gap; the legislature will evaluate this proposal and many other ideas in adopting the final solution.

Terms and Definitions for the Graphic

Adjusted Base Assumptions

These assumptions basically say how much a family spent in 2010 for things that they have committed to paying for in 2011, 2012, and 2013. Examples for a family might include the mortgage, utilities, and food. These cost assumptions include some adjustments for inflation, but do not fully account for inflation.

Present Law Caseload Increases

These assumptions generally add to the adjusted base and take into account changes in the budget that do not expand lifestyle, but take into account changes in the family. Examples might include: a baby being born, high school activity fees, more food consumption, and areas of inflation not already considered.

Current Services Level

This is an unusual category of cost. Usually in the analysis of the budget we would stop here and say that everything else is a lifestyle upgrade, or in state budget lingo, "new proposal". In this biennium, it is meaningful to consider these types of costs. In our state/family budget for 2011 we are spending more than we have committed to spend in the future. Some of these expenses are purchases of assets like buildings, vehicles, and remodeling and other expenses are supporting our lifestyle.

When we set the budget that we set in 2009, we thought revenues/incomes were going to stabilize or improve, and they have not. They continued to fall through 2010. Again, we think revenues will improve from here, but not to the level we thought. Knowing that revenues were uncertain, we improved or held on to lifestyle of 2009, but did not commit to those improvements for the long term.

Examples in a family might look like this: You know that your work hours have been reduced by 5% in 2009 and the reduction could go as high as 10%, but your boss thinks the economy will improve, and by 2011 he thinks you will be back to full employment. The choices they make maintain most of their adjusted base and present law items listed above in 2009, but they preliminarily determine that they will give up certain items if their hours do not return.

In the green box in the earlier chart are items that were not additional services in 2009, but are considered new in 2010 and 2011 2% inflation for schools and 2% for providers of health services. These are increases from the 2009 actual spending level, but not increases in 2010 and 2011.

Given that the items in the green box are not one-time in nature, nor are they improvements in lifestyle, they were included for consideration in this analysis.

Pension Funds

The state sets aside money to cover the retirement of state employees. When the market fell in 2008, the value of the funds set aside to pay these expenses fell. The expenses they are obligated to pay did not fall. The amount in the purple box in the chart is the amount necessary to maintain the obligated level of pensions to state employees.

A family situation can be similar. For example, when stock market conditions erode the value of your retirement plan, it takes additional savings to offset the loss in value.

Not Included in the Calculation

A number of other issues are not included in the calculations. Therefore, any additional costs for these items will add to the potential budget gap. These might include:

State employee pay plan or health insurance increases
Fire costs beyond the amount in the Governor's emergency fund
Any potential lawsuit settlement costs
Inflationary adjustments for provider rates, rents, food, fuel, or other contracts
Water compact distributions to the Blackfeet or Gros Ventre tribes
Supplemental appropriations for the current year not anticipated by the 2009 Legislature
New programs or services

Changes since October Analysis

Increased FMAP rates – increased cost $5 million
Error in calculation of DPHHS conversion to adjusted base – increased cost $14 million
Higher anticipated caseloads in DPHHS – increased cost $5 million
Updated School funding costs – cost increase of $15 million
Updated Retirement costs - cost reduction of $3 million
RTIC revenue update - increased revenues $8 million

KEY FACTORS OF THE ANALYSIS

Revenue Forecast

The revenue used in this analysis comes from the revenue estimate adopted by the Revenue and Transportation committee on November 19th as the starting point for HJ 2.

Budget Gap is the Structural Balance[1] of Current Services in the General Fund

In the analysis of the gap, the structural balance between current service levels, including actuarial soundness of the retirement systems, and HJ 2 revenue estimates for FY 2013 is negative by about $183.5 million or 9.1%.

Beginning Balance for the 2013 Biennium[2] Has Improved

The anticipated ending fund balance for the 2011 biennium, which is the beginning fund balance for the 2013 biennium, has improved dramatically since originally forecast in March. The lowest estimate in March before any subsequent improvements was as low as negative $63 million. As of December 2010, the Legislative Fiscal Division estimates a 2011 biennium ending fund balance of $200.2 million. The following table summarizes the changes in the 2011 biennium ending fund balance:

Item	*Amount (in millions)*
MCA 17-7-140 spending reductions of all three branches	$41.0
Federal – Tier 3 FMAP	19.3
Federal – Tier 3 FMAP application to "claw back"	8.4
Federal – Enhanced FMAP extension to June 30, 2011	25.0
Federal – Additional education ARRA (stimulus)	30.7
Otter Creek coal bonus payment	81.5
FY 2010 revenue higher than February estimate	34.9
FY 2011 revenue current estimate higher than February	10.5
Fund balance, prior year adjustments, and other	(9.0)
Supplemental appropriations	(2.9)
Transfers proposed by the executive	23.8
Total	$263.2

[1] Structural Balance is the difference between revenues that are expected to continue compared to costs that are expected to continue. A positive structural balance has revenues exceeding spending. A negative structural balance has spending exceeding revenues. A budget can be balanced without structural balance when one time revenues are added or fund balance (checking account balance) is spent down.

[2] Ending fund balance is the level of fund balance anticipated at the end of the two year budget period or biennium.

LEGISLATIVE PREPARATION FOR CLOSING THE BUDGET GAP

INTERIM WORK OF THE LEGISLATIVE FINANCE COMMITTEE

Having understood the magnitude of the financial challenges of the general fund, the Legislative Finance Committee did significant pre-session work to begin to find solutions.

- Developed a "Reference Book", which is a list of options available to the legislature to address the budget gap. The book has had public hearings and been reviewed by policy and budget interim committees. These options are available online at: http://leg.mt.gov/css/fiscal/reports/2011-session.asp
- Adopted a key recommendation to adopt the 5% plans required in MCA 17-7-111 as a part of the starting point for subcommittee deliberations with the director to draft required legislation. These options are available in each applicable agency throughout Volumes 3 through 7 of the LFD budget analysis
- Devised a clearer picture of statutory appropriations and state special funds. This information has been presented to the committee and many of these options will be presented to the legislature during session. For a list of the state special funds and their revenue streams see Volume 8 Reference. For a list of general fund and state special fund statutory appropriations see page 62 of this volume

The significant impacts of this work are that more choices will be available for legislative deliberation, including statutory appropriations and state special accounts.

CHOICES

After significant interim work of the Legislative Finance Committee and other committees included in the effort, the primary areas of choices available to the legislature include:

- Ending fund balance: The legislature could adopt some reduction in the ending fund balance to offset spending reductions
- Transfers from state special accounts: As was considered in several of the Reference Book items and by the Governor in his budget recommendation, the legislature could adopt some transfers from state special funds to the general fund
- Retirement $65.4 million: The cost to actuarially fund the pension systems could be only partially addressed, addressed in a way that did not cause as much general fund cost, or delayed until the next biennium as recommended by the Governor. For more information see page 120 of this volume
- Current Service Level $105.8 million: All or some portion of the health services, provider rates, tuition reduction, and school funding items that comprise most of these costs could be eliminated.
- 4% Personal Services Reductions $15.7 million: The legislature could accept the 4% reduction in personal services recommended by the Governor.
- 5% plans $96 million: The law (MCA 17-1-111) requires the executive to submit plans to reduce the general fund and most state special funds by 5%. The legislature could choose to adopt some of the items included in the 5% reduction plans submitted by the executive that were not included in other areas.

- Reference Book: Many ideas for reduction are presented in the Reference Book developed by the Legislative Finance Committee, interim committees, and the Legislative Fiscal Division. Items include:
- Some of the items are not reviewed regularly. A more full discussion of these items follows:
  - Statutory Appropriations
  - State Special Accounts
  - Tax Credits
- Some other Reference Book items will be raised in the budget analysis and within the subcommittee process
- Tax increases and other items requiring legislation, may be introduced by legislators interested in those policy choices

Items from the Reference Book with Follow up Work Requested:

Statutory Appropriations

Statutory appropriations are appropriations authorized by the legislature to be established each year without additional legislative action. Each legislature does not consider these appropriations as it considers each appropriation in the general appropriations bill: HB 2. There are several reasons that statutory appropriations are created:

- The pre-authorization has a financial benefit to the state, such as the statutory appropriations for debt service are looked upon favorably by rating agencies and may impact the bond rating of the state and interest rate paid on the debt
- The legislature may wish to express an ongoing commitment to the beneficiaries, such as the entitlement share for local cities and counties
- The amount of the appropriation is an unknown dollar amount, but an ongoing commitment. Examples of this may be state contributions to local government employees retirement cost as a percent of payroll or the local government share of the oil and gas tax revenues

Statutory appropriations have grown an average of 7.0% per year for the past 8 years. The largest growth in statutory appropriations is in state special accounts.

State Special Accounts

State special accounts are state funds designated for specific purposes. In FY 2010, 44% of state funds were categorized as state special. State special funds have grown an average of 8.9% over the past 8 years. Examples of the increases to these funds include:

- Several additions to state special revenues have been made by initiatives such as: I-146 redirection of Tobacco Settlement Funds from the general fund to state special accounts, I-149 addition to the tobacco tax and direction to state special accounts, and I-155 the redirection of insurance tax proceeds from the general fund to a state special account.
- Other items have been legislative action to move one-time funds to state special accounts such as the fires and school facilities.
- Other growth has been caused by changes in the economy such as the growth in oil and gas revenues has increased certain state special accounts.

- Some state special accounts may factor into tax policy as the funds entering these accounts are sometime set asides of tax revenue.

Tax Credits

As tax credits are a reduction in the amount of taxes owed, some view these as an expenditure of tax revenue. Reducing tax credits would increase general fund revenue and help solve the spending gap.

BUDGET RECOMMENDATIONS OF THE GOVERNOR

On December 15th the Governor recommended the following budget.

Executive Budget Proposal - General Fund
Figures in Millions

	Actual FY 2010	Estimated FY 2011	Requested FY 2012	Requested FY 2013	2011 Biennium	2013 Biennium	Biennial $ Change	Biennial % Change
Beginning Fund Balance	$396.334	$314.880	$271.320	$233.990	$396.334	$271.320	($147.208)	-37.1%
Revenue								
Executive Revenue Estimate	1,627.145	1,732.040	1,796.470	1,887.550	3,359.185	3,684.020	(402.323)	-12.0%
Executive Revenue Proposals		23.830	43.230	3.110	23.830	46.340	23.830	100.0%
Total Funds Available	$2,023.478	$2,070.750	$2,111.020	$2,124.650	$3,779.348	$4,001.680	($525.700)	-13.9%
Disbursements								
General Appropriations	1,575.921	1,570.370	1,661.730	1,666.770	3,146.291	3,328.500	(251.832)	-8.0%
Statutory Appropriations	169.872	181.240	189.990	199.550	351.112	389.540	(71.236)	-20.3%
Transfers	88.877	49.300	16.420	12.860	138.177	29.280	(135.104)	-97.8%
Other Appropriations	-	74.150	12.620	5.130	74.150	17.750	74.150	100.0%
Supplemental Appropriations	-	2.850	-	-	2.850	-	2.850	100.0%
Feed Bill	-	7.630	1.920	7.480	7.630	9.400	7.630	100.0%
Reversions	(117.960)	(90.350)	(5.650)	(5.680)	(208.310)	(11.330)	(43.578)	20.9%
Total Disbursements	$1,716.710	$1,795.190	$1,877.030	$1,886.110	$3,511.900	$3,763.140	($417.120)	-11.9%
Fund Balance Adjustments	8.112	(4.240)	-	-	3.872	-	(16.433)	-424.4%
Ending Fund Balance	$314.880	$271.320	$233.990	$238.540	$271.320	$238.540	($125.013)	-31.5%

The Governor's budget recommends revenue estimates that are higher than those adopted by the Revenue and Transportation Committee and other various policy choices to close the gap and balance the budget.

GAP CLOSING RECOMMENDATIONS OF THE GOVERNOR

Key elements of the Governor's proposal to close this gap from the current service level include the following:

- On December 15th the Governor proposed using revenue estimates for the 2013 biennium that are $104.3 million higher than the HJ 2 level adopted by the Revenue and Transportation Committee
- Under the November 15th budget, the Governor used $111.2 million of ending fund balance to pay for current expenses. With the increased revenues that the Governor released on December 15th, the Governor proposes using $32.8 million of ending fund balance to pay for current expenses
- The Governor would transfer and use $71.4 million from state special account balances to pay for current expenses.
  - Treasure State Endowment Program funds for one biennium for $22.5 million
  - $20 million out of a $22 million in the fire suppression fund
  - A reduction in the amount of savings for school facilities obligations by $20 million

    - 50% of the revenue into the economic development fund for the 2013 biennium or $2.9 million
    - $6 million from the coal bed methane account for compensation of damages due to coal bed methane development
- The Governor recommends shifting current general fund expenditures to state special revenue funds:
    - The use of 90% of the local school district oil and gas revenues to pay for the quality educator component of the school funding formula or $72.9 million
    - The use of the savings account for school facilities for the current general fund obligation to pay the state share of school debt service or $17.2 million
- The recommendations for closing the gap from the present law level include:
    - $1.1 million reduction in statutory general fund spending by using other university system funds to support a portion of the Optional Retirement Program (ORP)
    - $10.5 million reduction in the statutory inflation rate for the entitlement share payments from the state to counties and cities
    - A selective 4% reduction in general fund personal services or $15.7 million; note that this 4% reduction is 1% greater than the additional 3% vacancy savings imposed last biennium on agencies, although it is applied only to general fund
    - The proposal does not include updated school funding costs of $6.9 million in FY 2011 and $15.0 million in the 2013 biennium
- The recommendations for closing the gap from the current service level include:
    - $22.7 million savings in the current service level to not reinstate 2% entitlement amounts for K-12
    - $1.8 million reduction from the current service level by not reinstating the same level of economic development funding in the Department of Commerce.
    - Reducing current services in the Department of Public Health and Human Services by $26.0 million, including the 2% provider rate increases and direct care worker increases
- Not addressing the pension issues in this biennium, a savings of $65.4 million in the 2013 biennium

The above totals $456.8 million, more than enough to balance the budget. The Governor also has other changes, including net tax proposals that reduce revenue by $25 million, a pay plan for $15 million, some higher and some lower assumptions in higher education, some higher and some lower assumptions in health and human services, and many other offsetting differences. The net result is a balanced budget that, using the Governor's revenue estimates, would leave an ending fund balance of $238.5 million.

Note: Also contained in the Overview on page 132 is a comparison of the Governor's changes from the executive's calculated present law budget i.e. not including pensions and other current service items, but including other items considered present law by the executive. This analysis is a very similar

POLICY CONCERNS WITH THE GOVERNOR'S PROPOSED SOLUTION

Structural Balance

As stated earlier, the underlying structural imbalance pressure estimated by the LFD is $183.5 million. The Governor's proposed solution narrows but does not eliminate this imbalance.

Structural Balance Comparison	FY 2012	FY 2013
Underlying Structural Balance	$ (199.3)	$ (183.3)
Governor's Revenue Assumptions	42.7	60.6
Net Governor's stuctural balance changes	52.1	49.0
Recognized Stuctural Balance	(104.4)	(73.8)
Not Recognizing K-12 costs	5.6	9.4
Not addressing Retirment systems	29.8	35.7
Governor's Structural Balance Dec. 15	**$ (69.1)**	**$ (28.7)**

The Governor's December 15th revenue assumptions increase the annual revenue and decrease the structural balance. As stated, these estimates are higher than the revenue level adopted by the Revenue and Transportation Committee for HJ 2.

The Governor's budget does not recommend elements of the current service level budget described on pages 4 and 5:

- $52.1 million in FY 2012 and $49.0 million in FY 2013 of the reductions are due to discontinuation of the provider rate increases for the Department of Health and Human Services and the 2% entitlement increases for K-12 schools, selected 4% general fund personal services reductions, and various other recommendations
- The Governor did not recognize the additional costs for K-12 funding in the 2013 biennium
- Actuarial underfunding of the retirement systems was not addressed

In addition, several of the Governor's proposals have structural balance implications for the future:

- The revenue into the school facility account may be insufficient to cover the debt service obligations of the state in the long run and this obligation may need to return to the general fund
- The pay plan proposed is weighted heavily to the next biennium and creates an additional $7.5 million each year of ongoing general fund obligation
- There are additional pressures in other state special accounts where the fund balance was transferred to the general fund or costs shifted from the general fund to the state special account. Several of the state special accounts are either over spent or will be in the future, putting future pressure on the general fund

Unless revenues are as high as the Governor recommends, the sum of these factors could leave the underlying structural imbalance going into the next biennium at $150 million or more per year or about 8% of the annual revenue.

One issue for the legislature is whether, in tight fiscal times, some level of structural imbalance may be worth the risk. Likewise, in strong fiscal times such as the 2009 biennium, the question is whether to commit to higher levels of spending when revenues are increasing. In the 2009 biennium the executive proposed and the legislature left $78 million of anticipated structural surplus unspent.

Revenue Growth and Structural Balance

If final legislative adopted revenues are higher than current HJ 2 estimates, the structural imbalance will be less and the risk will be correspondingly less. For more information on the economic trends and current revenue estimates, see page 17 and the Revenue Overview section.

If revenue growth were expected to grow rapidly in the 2015 biennium, the risk of structural imbalance may have been mitigated. Revenues in the 2015 biennium are anticipated to grow at or near the long-term average growth rate or approximately 4% per year. Normal growth in the spending often requires most of this increase.

> While the legislature contemplates issues from more than just a financial perspective, the primary focus of this analysis is financial.

From a financial perspective, the risk associated with negative structural balance is significantly higher than the risk for positive or surplus structural balance. Negative structural balance, or spending above the state's means, leads to continued financial strain, erosion of savings, and less long term financial security. This problem was experienced by Montana in the late 1980's and early 1990's. A positive ending fund balance provides for growth and an opportunity for an increase in savings or capital investment. Montana experienced this during the high revenue growth period from FY 2004 to FY 2008.

Other Risks of the Governor's Proposal

Reduction of Savings Accounts

The Governor's budget contains the transfer of fund balances that the state relies on for emergencies and for future public infrastructure investment. These items decrease the state's savings funds and are explained in detail on page 128. Examples include:

- $33 million reduction of ending fund balance
- $20 million transfer from the fire suppression state special fund. This fund is the source of funding for emergency fire protection, and without this the general fund is the only source of funding for state obligations to pay for fires
- School facilities of $20 million. This fund was created to fulfill the legal obligation of the state to contribute to school facilities.
- Treasure State Endowment and Regional Water funds for one biennium for $22.49 million
- $6 million from the Coal Bed Methane account for compensation of damages due to coal bed methane development

- 50% of the revenue into the economic development fund for the 2013 biennium or $2.9 million

Shifting Expenditures

The Governor's budget shifts some spending from the general fund to state special funds. As these state special funds are currently being used for other functions, the proposals rely on the willingness of the legislature to shift this funding away from current programs and into programs currently funded with general fund.

$72.9 million of the budget relies on the passage of a bill that removes 90% of the oil and gas revenues from school districts and uses those funds to replace general fund obligations. This bill would have significant impacts on districts that receive material amounts of oil and gas funding. Considerations by the legislature include:

- Tax implications to the districts
- That oil and gas are depleting resources and may not provide enough funding over the long term.
- The use of the savings account for school facilities for the current general fund obligation to pay the state share of school debt service or $17.2 million

Ending Fund Balance

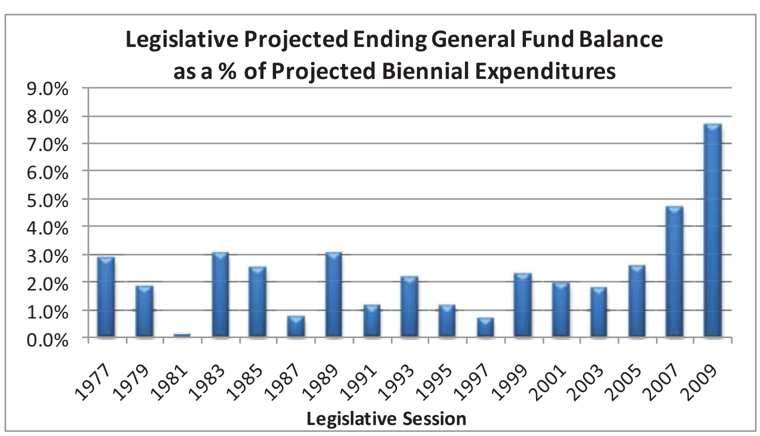
The Governor's original budget recommends a minimum ending fund balance of $125 million. The revised budget with higher revenue estimates has a $238.5 ending fund balance. Factors impacting the Governor's ending fund balance estimate are:

- The Governor chose not to include available updates in the general fund cost for schools. The additional cost of these items is $21.9 million over FY 2011, FY 2012, and FY 2013
- Over the three year period of FY 2011, FY 2012 and FY 2013 the HJ 2 revenue estimate is $164.2 million less than the Governor's December 15 estimated revenue.

The 2013 estimated ending fund balance using HJ 2 revenues and updated school funding numbers is $55.6 million. See page 15 for more details.

Given the Current Level of Economic Risk, What Level of Ending Fund Balance is Appropriate?

As described in more detail on page 97 regarding ending fund balances, a national rule of thumb for setting projected ending fund balances is between 3% and 5%, or $108 million to $180 million of the budget period expenditures.



If the legislature feels that the revenue estimates have more upside than downside risk, it could be argued that a lower ending fund balance is appropriate. If the reverse is true, a larger ending fund balance would be reasonable. In addition, when multiple savings funds other than ending fund balance are available in an emergency, it can be argued that ending fund balance could be safely lower.

Historically, the projected ending fund balance has varied from 0.1% to 7.7% of biennial expenditures.

If the anticipated ending fund balance is less than 1% of the biennial expenditures MCA 17-7-140 will trigger and require the Governor to make spending reductions. Under current law, the legislature would need to set the anticipated ending fund balance in excess of approximately $36 million to be above this trigger level.

GOVERNOR'S BUDGET UPDATED WITH HJ 2 AND K-12

The following table summarizes the Governor's budget with updated figures:

LFD Estimates with Executive Proposals - General Fund Outlook
Figures in Millions

	Actual FY 2010	Estimated FY 2011	Requested FY 2012	Requested FY 2013	2011 Biennium	2013 Biennium	Biennial $ Change	Biennial % Change
Beginning Fund Balance	$396.334	$314.880	$207.093	$126.302	$396.334	$207.093	($189.241)	-47.7%
Revenue								
HJ2 Revenue Estimate	1,627.145	1,672.133	1,753.767	1,825.963	3,299.277	3,579.731	280.453	8.5%
Executive Revenue Proposals		23.830	43.230	3.110	23.830	46.340	22.510	94.5%
Total Funds Available	$2,023.478	$2,010.843	$2,004.090	$1,955.375	$3,719.441	$3,833.163	$113.723	3.1%
Disbursements								
General Appropriations	1,575.921	1,533.314	1,701.756	1,704.751	3,109.235	3,406.507	297.272	9.6%
Executive New Proposals	-	-	(27.413)	(32.848)	-	(60.261)	(60.261)	
Statutory Appropriations	169.872	180.683	189.618	197.180	350.555	386.798	36.243	10.3%
Transfers	88.877	49.144	16.741	12.426	138.021	29.167	(108.854)	-78.9%
Other Appropriations	-	139.737	-	-	139.737	-	(139.737)	-100.0%
Supplemental Appropriations	-	2.851	-	-	2.851	-	(2.851)	-100.0%
Feed Bill	-	9.818	2.469	10.009	9.818	12.478	2.660	27.1%
Reversions	(117.960)	(112.263)	(5.383)	(6.686)	(230.223)	(12.069)	218.154	-94.8%
Total Disbursements	$1,716.710	$1,803.284	$1,877.788	$1,884.832	$3,519.994	$3,762.620	$242.626	6.9%
Fund Balance Adjustments	8.112	(0.466)	-	-	7.646	-	(7.646)	-100.0%
Ending Fund Balance	$314.880	$207.093	$126.302	$70.543	$207.093	$70.543	($136.549)	-65.9%
Executive Budget Adjustments								
Less Guarantee Account Revenue			1.024	5.478	-	6.502		
More Public School Costs		6.885	4.528	3.956	6.885	8.484		
Total Adjustments		$6.885	$5.552	$9.434	$6.885	$14.986		
Revised Ending Fund Balance		$200.208	$113.86	$48.67	$200.208	$55.557		

The key differences include:

- Revenue estimate difference from the level adopted by the Revenue and Transportation Committee adopted revenues for HJ 2 reduces the ending fund balance by $164.2 million
- Updated costs for K-12 schools reduce the ending fund balance by $21.9 million

The remaining $3.188 million of higher ending fund balance is the result of many small differences in the balance sheet items such as: prior year adjustments, statutory appropriations, feed bill assumptions and reversion estimates

GOVERNOR'S BUDGET POLICY QUESTIONS

In addition to the high level financial policy questions before the legislature, the Governor's budget proposes several other policy choices.

Pay Plan: The pay plan increases state employee pay by 1% on January 1, 2012 and by 3% on January 1, 2013. The legislature will need to weigh the needs of additional pay for employees against the budget pressure facing the state. For an analysis of the pay plan, please see page 99.

Local Government Funding: Several of the reductions in spending or transfer come from state funding for local governments.

- Entitlement Share: The Governor has recommended limiting inflationary increases for the state payment to cities and counties to 0.76%. The Legislative Fiscal Division has done analysis on the history of this payment that it is contained in the Major Issues section page 90.
- Treasure State Endowment: The executive proposal eliminates treasure state endowment and regional water grants for the 2013 biennium.

School Funding: the Governor proposes several changes in school funding:

- The funding sources for two of the components of the school funding formula – quality educator and debt service guaranteed tax BASE aid - would change from the general fund to specific state special funds. The legislature authorized a 2% entitlement increase in each year of the biennium allocated on a one-time basis. The Governor does not continue this 2% amount.
- The Governor's action relative to the school facility fund lessens the long-term commitment of the state to school facilities. Reallocating revenues formerly committed to school facilities and directing them toward current general fund obligations for debt service also erodes the commitment.

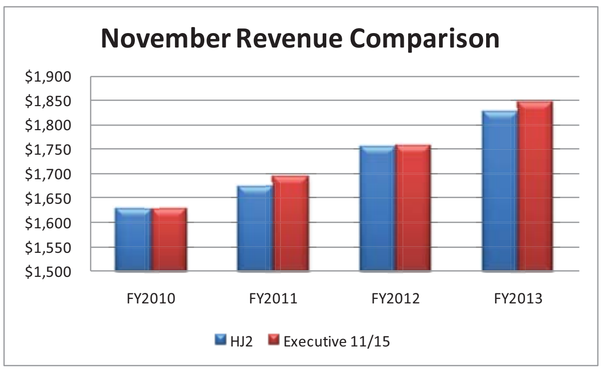
Higher education funding: The executive recommended biennial increase in general fund for the Montana University System and community colleges is 9.0% (adjusted to HB 645) compared to the statewide average increase in the biennium of 3.6% (see Expenditure section for more detail).

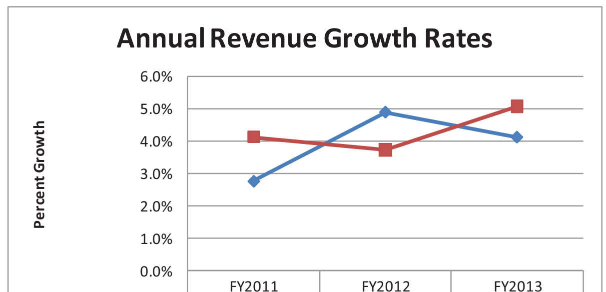
Department of Public Health and Human Services (DPHHS) caseload estimates: The caseload estimates appear to be restrained. LFD staff prepares independent estimates for selected Medicaid services. Historically, LFD staff has considered Medicaid caseload estimates jointly with DPHHS staff, including discussions of the model used by DPHHS, cost trend assumptions, and various discrete changes made to estimates. This process was not available to LFD staff as part of the 2013 biennium budget development. Therefore, the ability of LFD staff to analyze Medicaid caseload estimates included in the executive budget is not as complete as in past years, also contributing to the level of risk in establishing Medicaid cost estimates. Given the magnitude of this estimate, it may be worth investing in the development of an independent Medicaid estimate similar to how the LFD estimates revenues.

Capital investments: the Governor recommends reducing the state's previous commitments to capital projects in information systems and buildings. In addition, the recommendation has little spending to maintain current infrastructure.

CAUTION ON REVENUE ESTIMATES

In November, the executive and the Legislative Fiscal Division recommended economic assumptions and associated general fund revenue estimates to the Revenue and Transportation Interim Committee. The total difference between the two estimates over the three year period was $45.5 million or 0.87%.





	FY2011	FY2012	FY2013
HJ2	2.8%	4.9%	4.1%
Executive 11/15	4.1%	3.7%	5.1%

The executive growth rates anticipated for FY 2011 through FY 2013 are illustrated in the chart above at 4.1%, 3.7% and 5.1% respectively.

In December, the executive chose to revise its FY 2011 forecast based on year to date (YTD) revenue collections in comparison to average collections for the past 11 years. YTD analysis is frequently used to evaluate forecasts for reasonability. In the last half of a fiscal year these numbers are often used to give indications if the forecast is on target, high, or low.

YTD analysis has advantages and disadvantages:

- The positive aspect includes that although it is a snapshot in time, represents actual collections to date
- The negative aspects include:
- One data point does not necessarily indicate a trend
- The variability of actual collections to YTD collections range widely
- Mid-year data could have unusual accounting or collection issues, causing a variation in final collections.

Comparison	% Collection Through November	Implied Full Year Collections
Highest %/Lowest Collections	29.7%	$1,546.8
Lowest%/Highest Collections	25.1%	$1,828.2
Average%/Collections	26.9%	$1,708.9
Difference between the High and the Low		$281.4

To illustrate the variability, the last nine years of data was examined and the results applied to the current YTD revenue collections. The fluctuation has been significant - approximately 16% or a $281.4 million range between the high and low years. This wide a variation may not make for a consistent method of revenue forecasting. While year to date analysis is an excellent tool if determining reasonableness of a forecast or for testing if current year revenues are close to the estimated level, it is not necessarily the most accurate for forecasting purposes.

Note: FY 2000 and FY 2001 were not used since revenue streams were materially altered beginning in FY 2002 and the new accounting system had not stabilized yet in those two years. The Legislative Fiscal Division generally does not use those years for analysis purposes.

Executive Change in Forecast

After adjusting the FY 2011 forecast, the executive then extrapolated this to the 2013 biennium. The previously assumed growth rates in FY 2012 and FY 2013 were applied to the new base, FY 2011. It should be noted that no evaluation of the economic conditions that produced the original forecast has been presented. A preferable method would include an analysis of economic conditions.

The resulting revenues for the three year period are as follows: