2019 BIENNIUM OUTLOOK
FOR THE GENERAL FUND BUDGET

A Report Prepared for the
Legislative Finance Committee

By
Legislative Fiscal Division

Updated June 16, 2016

LFD
MONTANA LEGISLATIVE FISCAL DIVISION

INTRODUCTION

The purpose of this report is to provide perspectives on the upcoming 2019 biennium budget. The report provides the current outlook for ongoing general fund revenues and expenditures to project the general fund the legislature will have available for the 2019 biennium. The report includes a summary of findings, with further elaboration on:

- Anticipated ongoing general fund revenues
- Ongoing general fund present law expenditure requirements
- Budget pressures
- Risks associated with the budget

RISKS AND PRESSURES

The report contains a discussion of various risks and pressures that are not a part of present law but could impact spending or revenues. Present law base is defined in statute (17-7-102(10), MCA) as that level of funding needed under present law to maintain operations and services at the level authorized by the previous legislature.

"Pressures" are defined as those factors that are not within the statutory definition of present law and are not included in the present law estimate but that the legislature is likely to be under pressure to fund. In several areas these pressures are as compelling as present law.

"Risks" are defined as those factors that could render the projected present law different from actual present law in the next legislative session. For example, estimates of Medicaid costs and K-12 school funding are included in the present law estimate. Changes in any of these factors from the parameters used in the estimate will result in a different actual present law revenues or expenditures than the projected.

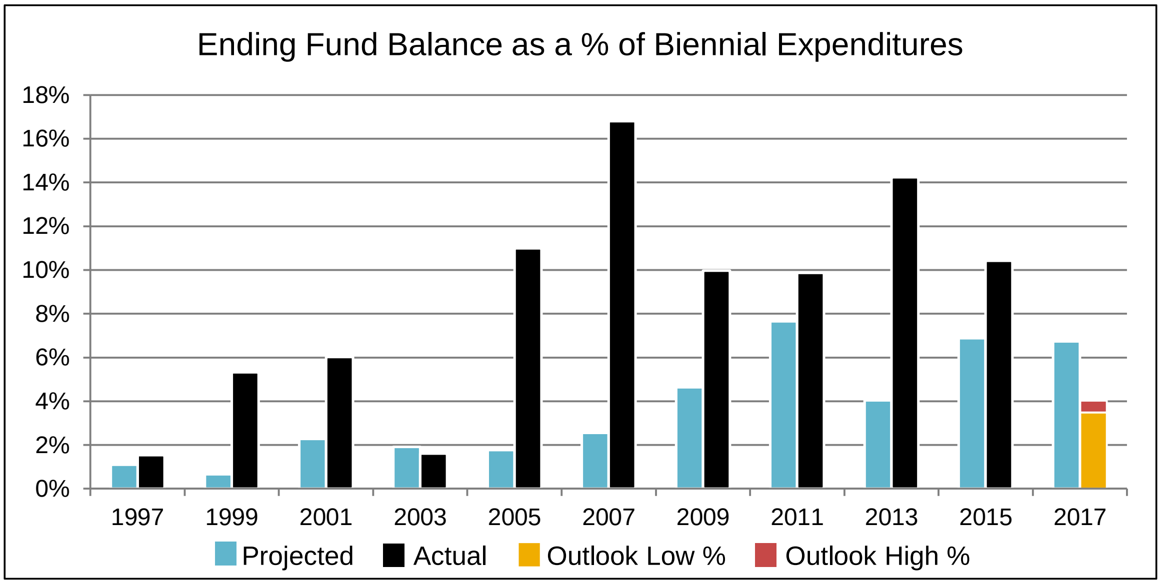
ANALYSIS OF FINDINGS

This report concentrates on the general fund, as it is the primary source used by the legislature to make funding decisions for general government services, such as education, health and human services and public safety. General fund ending fund balance (to include any rainy day fund) and structural balance are also generally used to determine the fiscal soundness of the state. For background information on these two measures, please see Managing Budget Volatility on page 30.

2017 BIENNIUM ENDING GENERAL FUND BALANCE

The 2019 biennium begins with the 2017 anticipated ending fund balance. At the end of the 2015 Legislative Session the 2017 ending fund balance was anticipated at $314 million. In FY 2015, revenues were greater than anticipated and expenditures were less than anticipated, which increased the anticipated ending fund balance to $357 million. Current 2017 biennium forecasts based on FY 2016 year-to-date revenues are about $166 million lower than the revenue estimate and if current income tax trends continue, could be $191 million lower. In addition to revenue impacts to the ending fund balance, expenditure impacts are anticipated. Slightly lower estimates for statutory appropriations and non-budgeted transfers of $4 million and higher costs for school funding of $7 million (statute directs the school BASE Aid formula and general fund supplemental appropriations provide for any shortfalls, per 17-7-301, MCA). Considering all these factors and standard assumptions for reversions, this would result in an ending fund balance between $163 and $188 million or approximately between 3.5% and 4.0% of 2017 biennial expenditures.

Actual general fund ending fund balances have generally been greater than the budgeted ending fund balances. Actual ending fund balances have been 9.9% or greater than projected since the 2005 biennia. In the most recent five biennia, budgeted ending fund balances have averaged 6%. The 2017 biennium budgeted ending fund balance was projected to be 6.4% of biennial expenditures and actual ending fund balance is anticipated to be between 3.5% and 4.0% of biennial expenditures as noted above.



This level of ending fund balance is relatively low compared to recent trends. The statutorily defined minimum ending fund balance (17-7-140, MCA) is anticipated to be approximately $127 million in the 2019 biennium. In the past ten years, the Legislature and Governor have budgeted ending fund balances at $250 million or greater. The 2017 biennium was budgeted at $314 million.

In order to return to an ending fund balance of $250 million, between $62 and $87 million of general fund revenue would need to be reserved from the 2019 biennium expenditures. A reserve of $62 million is shown as a potential impact to the 2019 biennium general fund budget on page 10.

STRUCTURAL BALANCE

Structural balance compares the anticipated ongoing revenues and ongoing expenditures to determine whether ongoing revenues are sufficient to continue to fund the legislatively authorized ongoing functions of state government. The estimate of the 2019 biennium general fund structural balance is positive, meaning that the current outlook for general fund revenue exceeds the anticipated present law level requirements for the budget. When pressures in addition to present law are included, the pressures exceed the present law revenue.

Present Law Assumptions

The chart on page six is a visual representation of projected general fund structural balance in the 2019 biennium. The chart shows:

- Anticipated ongoing 2017 biennial ongoing appropriations, which means the budgeted ongoing expenditures for FY 2016 and FY 2017
- The FY 2017 ongoing appropriation level, which brings biennial expenditures up to the level budgeted in FY 2017
- Strictly defined present law expenditure increases such as annualizing the pay plan approved in the 2015 session, Medicaid caseload growth, minor inflationary items, and statutory increases for K-12 Base Aid, local government entitlement share, and HELP Act

- Ongoing revenue forecast
- Ongoing revenue forecast risk of $55 million if the current lower individual income tax trend continues

Present Law Revenue Assumptions:

The Legislative Fiscal Division developed a revenue forecast for FY 2016 through FY 2019. This forecast uses current year revenue trends, current economic forecasts from IHS Econometrics, and other data. In mid-November of 2016 these forecasts will be further updated and include actual revenue for FY 2016.

<u>Present Law Revenue Assumptions</u>

HJ 2 estimated revenue growth from the 2015 biennium at 8.0%. Current revenue trends indicate that a growth rate for the 2017 biennium will be approximately 3.9% and 11.4% in the 2019 biennium. The primary cause for lower revenue growth in the 2017 biennium is lower energy commodity prices which reduce severance taxes and corporation income tax. In addition, the weak stock in the market growth negatively impacts individual income tax collections primarily through reduced capital gains income. For more detail on revenue estimates, please see page 12.

Baseline Forecast

The baseline forecast of the Legislative Fiscal Division (LFD) contains a general fund income tax forecast for FY 2016 that includes the dampened growth rate currently seen in FY 2016. However it is assumed that this dampened level is temporary as taxpayers have a one-time adjustment for reduced capital gains received in calendar year 2015. In this baseline forecast, the FY 2017 individual income tax collections make a rebound of 6.7%. At this time, it is uncertain whether the current dampened growth rate will continue. For more information see page 13.

Individual Income Tax Trend Risk Alternative Forecast

Given the risk inherent in the baseline forecast an alternative assumption for FY 2017 was created. In this alternative assumption the individual income tax revenue grows from the FY 2016 individual income tax level at typical rate of 4.7% in FY 2017. This makes a $25 million difference in FY 2017 and $55 million in the 2019 biennium. For more information see page 13.

Additional analysis will be performed over the next several months to determine if the baseline forecast should be amended to include the lower individual income tax assumptions.

<u>Present law expenditure assumptions</u>

The Legislative Finance Committee (LFC) has agreed to measure changes in the budget from the FY 2017 appropriated level as modified by the Governor. The expenditures described in this analysis begin from this level of appropriation and assumes that the Governor will authorize additional movement of budget authority to fully expend these appropriations.[1]

Present Law Adjustments

Present law adjustments from FY 2017 Base total $242 million, which includes $71 million in present law adjustments that reestablish the FY 2017 level of appropriations for the Office of the Public Defender and the Department of Livestock. Without these reestablishing items, the present law adjustments would be $171 million in comparison to the [2017 Biennium Outlook Report] which was $121 million.

Key elements of the present law increases include:

- K-12 BASE Aid funding increases by $48 million. Of this $48 million, $30 million is for inflation of the BASE Aid components, $11 million replaces funding for reductions in revenue received

[1] It is assumed throughout this report that the 2017 HB 2 Appropriations are spent within the law and that if savings are realized in one area, they are redirected and spent on items that will be considered base. Secondly, present law growth is measured from the Outlook forecast, which may be lower than estimated in the 2015 Session.

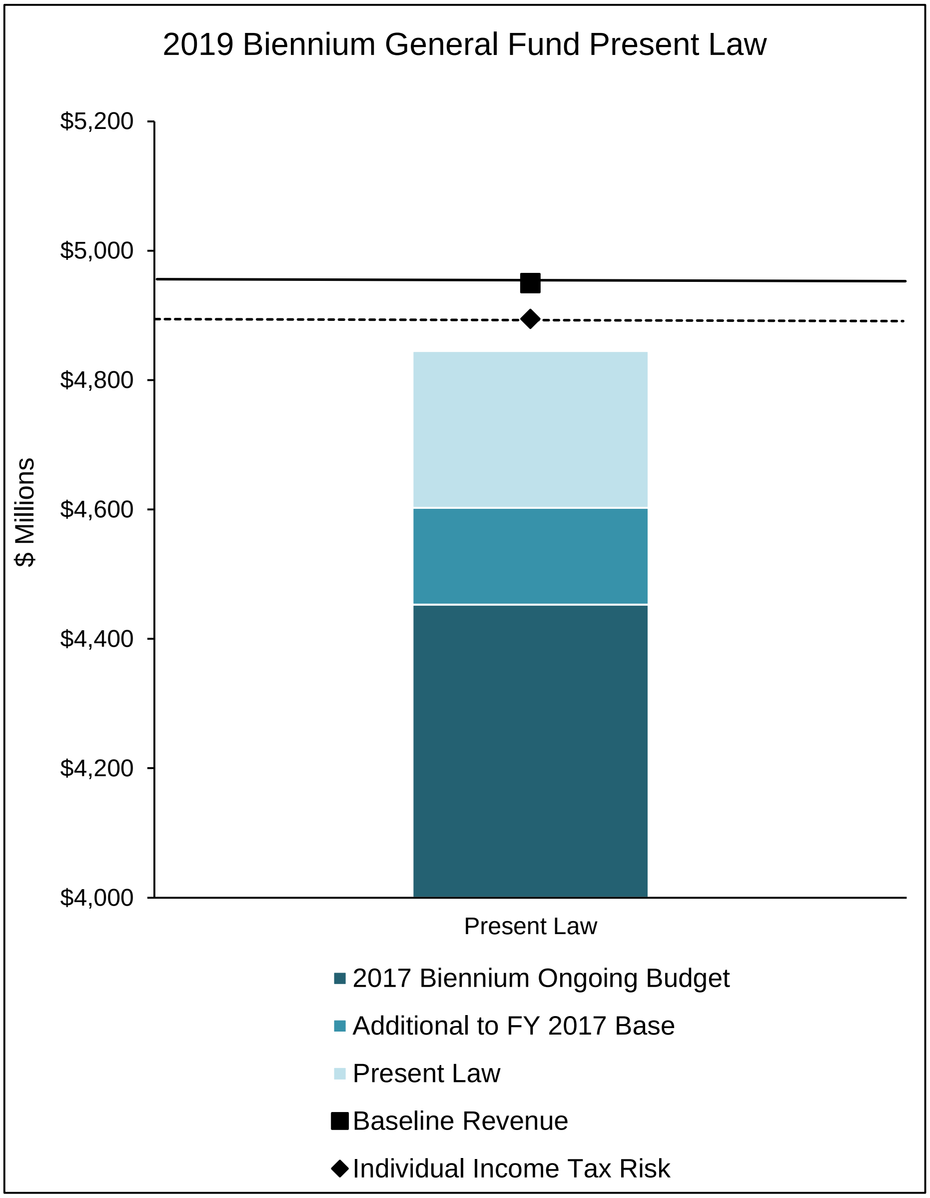
into the guarantee account, $4 million for additional enrollment, and $3 million for the natural resource payment. For more information see page 20

- Growth in statutory appropriations by $60 million
  - Additional statutory appropriation expenditures for enrollment and administrative appropriations for the HELP Act Medicaid expansion total $36 million over the anticipated FY 2017 expenditures. For more information see page 18
  - Retirement contributions total $15 million for state share to local government and school pension systems; and additional general fund contributions to amortize the pension systems sponsored by the state
  - Local government entitlement share increases $12 million
  - Lower bond payments by $3 million as bonds are paid off

  Increased present law costs for the Department of Health and Human Services (DPHHS) HB 2 budget of $31 million includes: Medicaid caseload $22 million, $5 million for caseload growth in Children and Families services, and $4 million of other adjustments for the DPHHS. For more information see page 18
- Increased present law costs for the Department of Corrections of $8 million, including $5 million for additional prisoners held in county jails, and other adjustments for the Department of Corrections. For more information see page 19
- All other adjustments throughout state government $24 million. For more information see pages 18-21

Present law chart

As described previously, anticipated ongoing present law expenditures are below projections of ongoing revenue. The projected revenue and present law spending trends may result in a structural balance of $105 million for the 2019 biennium, meaning that ongoing baseline revenues are greater than assumed present law spending by $105 million or 2.1% of anticipated biennial revenue. Alternatively, the Individual Income Tax Risk alternative forecast would decrease revenues by $55 million for the 2019 biennium. Even with the lower revenue alternative, ongoing revenues would be sufficient for present law ongoing expenditures.



Expenditure Pressure

In addition to present law adjustments, the legislature can anticipate additional expenditure pressures for services that currently are provided by state government. The 2017 general fund biennial expenditure growth was 8.0%. Overall the 2019 outlook forecast assumes total expenditure pressure growth of 4.3% to 8.1% in the 2019 biennium.

Additional expenditure pressures:

- Agency pressures or pressures for services that agencies anticipate or are currently providing with current resources
- Pressures for ongoing services that the legislature funded on a one time basis
- Inflationary increases for state purchased services such as health benefits and treatment facilities known as provider rate increases
- Inflationary increases for state employee pay known as the pay plan
- Shortfalls in other funding sources
- Funding for state and local infrastructure

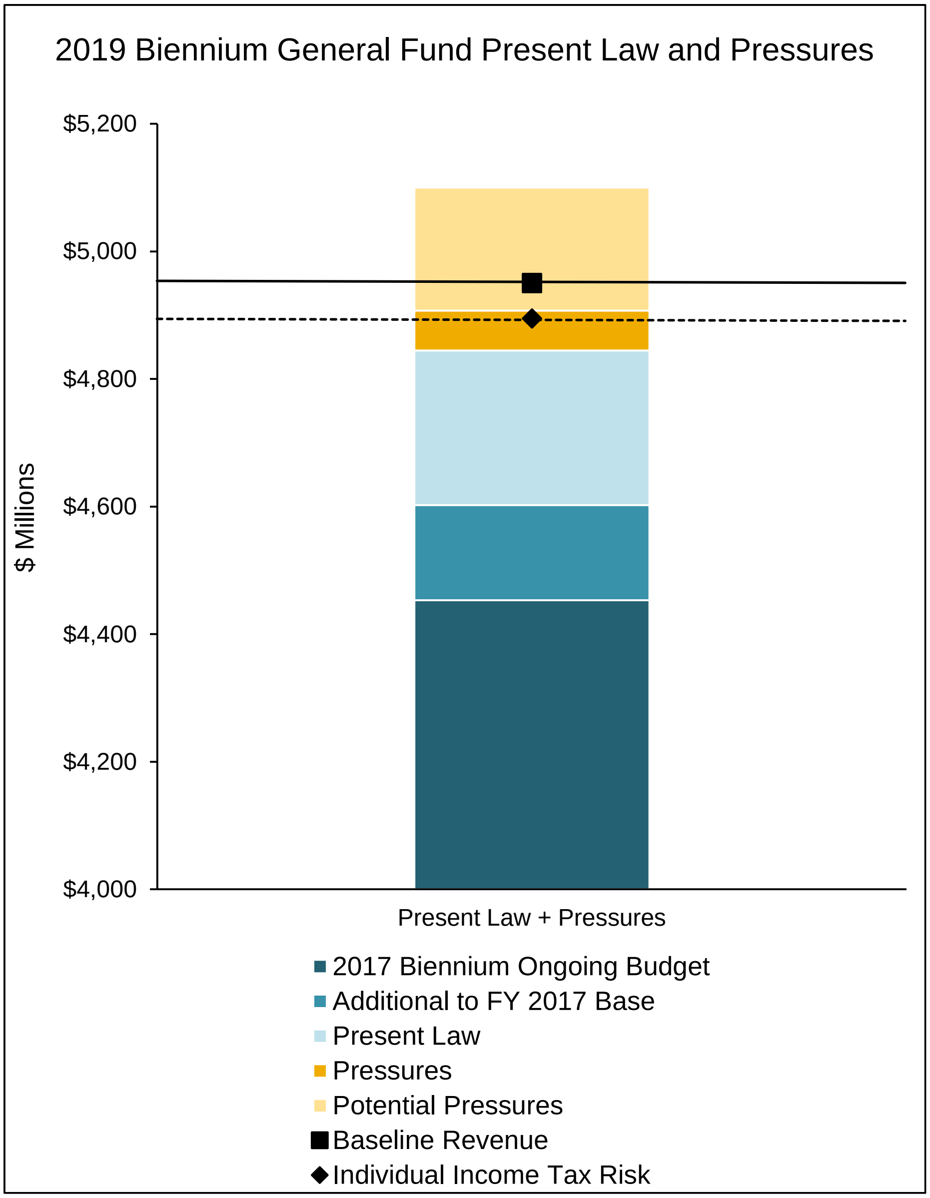
> Expenditure Pressure
> Department of Corrections Population
>
> Population increases may necessitate additional:
>
> - Hard cells at the primary men's facility at Deer Lodge
> - Treatment facilities for drug and alcohol addiction
> - Mental health treatment facilities
> - Pre-release community placement facilities
> - Probation and parole officers

Expenditure pressure for current services within state government extend beyond present law. In several cases, some items are historically deemed new proposals, due to the inherent policy decisions incorporated into the budget adjustment. One example is the population growth in the Department of Corrections. When budgets increase to fund new prisoners, the policy questions regarding where to place or house new populations are significant and lead policymakers to consider these choices new proposals.

The following table summarizes the expenditure pressures and the specific page numbers referring to the written narrative explaining each pressure in the report. The table shows two columns, one for the minimum amount projected to provide for the pressure and a second column for a potential or a higher level that may be necessary.

General Fund Pressures ($ Millions)			
	Minimum	Potential	Page
Agency Pressures			
Office of the Public Defender - Caseload increases	$4.8	$5.8	23
Department of Corrections - Caseloads in all areas	11.8	11.8	23
Department of Corrections - County jail rate pressure	1.7	3.0	23
DPHHS - Additional Federal waiver for Developmental Disabilities Services	2.4	2.4	23
DPHHS - Protect Montana Kids Initiative	1.0	1.5	23
Natural Resource revenue shortfall backfill with general fund	2.5	5.8	23
Judicial Branch - additional district court judges	-	2.3	24
K-12 Funding Study: waiting for Commission recommendations	-	-	24
Current Service Level: services funding with one-time appropriations			
Aquatic Invasive Species	1.0	1.9	25
Office of Public Instruction - Montana Digital Academy	0.8	1.7	25
Department of Administration - State Facilities Maintenance of Common Areas	1.6	3.3	25
Department of Commerce - Indian Country Economic Development	0.8	1.6	25
Department of Commerce - Tribal language	0.8	1.5	25
Department of Corrections - Lewistown Infirmary and Women's Prison	0.6	1.1	25
Judicial Branch - Information technology staff	0.2	0.4	25
Inflationary items: Provider Rate Increases (1% - 3%)			
Department of Public Health & Human Services (DPHHS)	10.9	32.7	26
Department of Corrections	1.6	4.8	26
Office of Public Defender	0.2	0.6	26
Inflationary items: Pay increases for state employees (pay plan) (1% - 3%)	14.0	42.1	26
Mitigating tuition increases for inflationary items for the Montana University System	-	12.8	26
State and Local Infrastructure			
State infrastructure historical level of general fund transfers	-	40.0	27
State Information Technology Infrastructure historical level of transfers	-	10.0	27
Local infrastructure grants such as Treasure State Endowment Grants	1.0	14.3	27
School Facility shortfall in revenue (includes school facility debt service)	4.8	21.6	28
Highway state special revenue fund shortfall	-	32.4	29
Total Pressures	$62.4	$255.4	

The chart below shows the projected present law expenditures, but also adds various budget pressures described on the previous page.

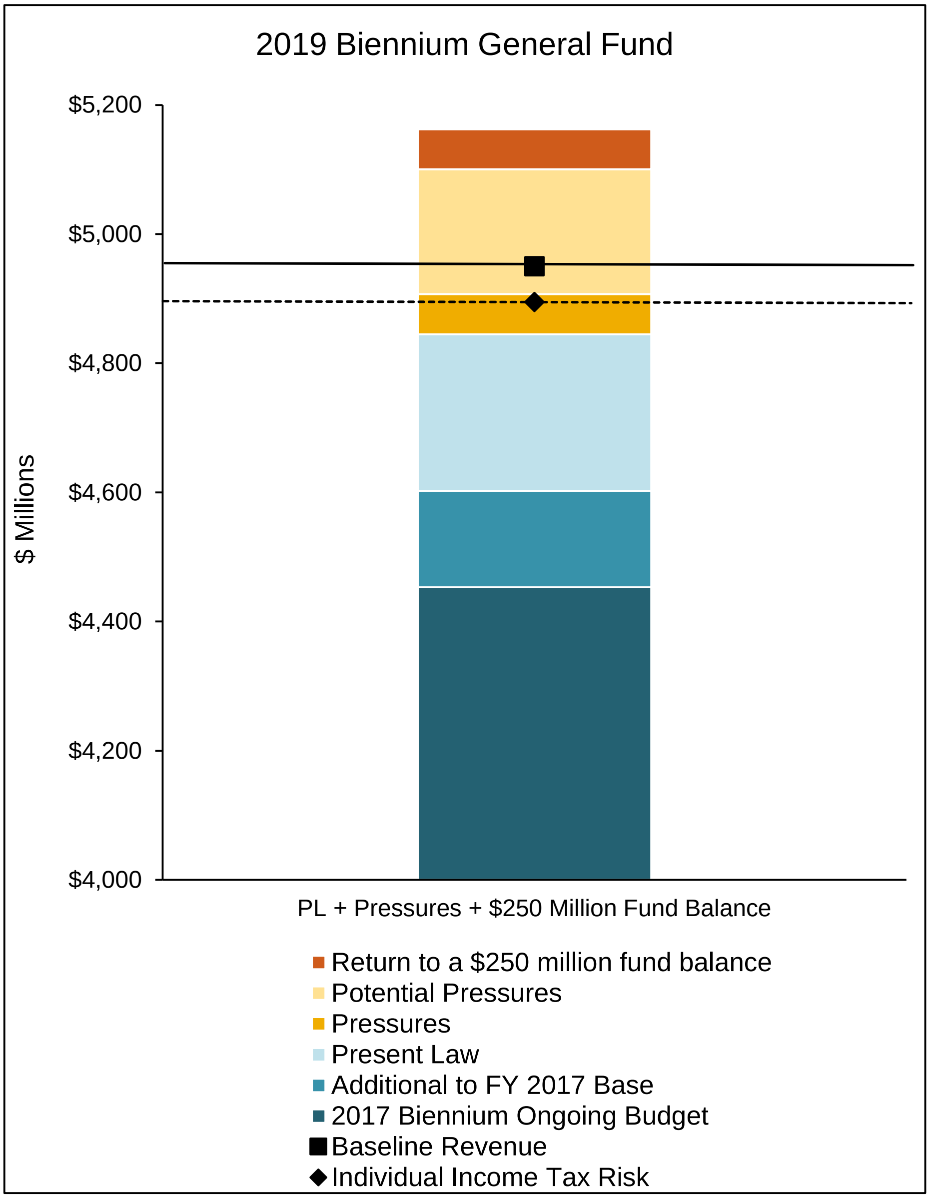


Structural Balance Recap

With the baseline revenue forecast, all expenditure pressures could be funded at the minimum level and $43 million of additional potential pressures could be funded. With the Individual Income Tax Risk alternative forecast which is lower by $55 million for the 2019 biennium, ongoing revenues would be insufficient to fund the minimum level of all expenditure pressures.

ONE TIME PRESSURE FOR 2019 BIENNIUM

As described in the 2017 Biennium Ending Fund Balance section on page 3, recent budgeted ending fund balances have been at least $250 million. With the assumptions in this report, and the baseline revenue estimate, if the Legislature chooses to budget a $250 million ending fund balance, $62 million of revenue from the 2019 biennium would need to be reserved. The graphic represents this analysis.



ALTERNATIVE EXPENDITURE ASSUMPTIONS

As discussed, several expenditure assumptions were required to develop this analysis. As typical, the assumptions of the Legislative Fiscal Division may or may not occur. These assumptions could improve, or worsen the ending fund balance or structural balance picture facing the Legislature next session. For example, no supplemental appropriations were included in the analysis except for K-12 BASE Aid. Additional supplemental appropriations could be approved, which would reduce the ending fund balance.

Conversely, only the standard level of reversions were assumed. However, current HB 2 Medicaid benefit expenditures are less than budgeted and may result in higher than anticipated reversions of general fund appropriations. These potentially higher reversions are uncertain as the Executive has the statutory ability to move these general fund appropriations to cover other expenses within the Department of Health and Human Services (DPHHS).

The following examples provide a range of alternative assumptions that may impact either the ending fund balance or structural balance:

2017 Expenditure Alternative Assumptions - impact fund balance *($ Millions)*		Page
Supplemental Pressure that could reduce ending fund balance		
Dept. of Justice: higher than anticipated costs for medical examiners	$0.8	19
Office of Public Defender: caseload higher than anticipated	3.5	19
Dept. of Corrections - Jail Holds	5.0	19
Total potential additional expenditures	9.3	
Potential for Higher Reversions that could increase ending fund balance		
Medicaid caseload: lower than HB 2 budgeted	26.4	18
Medical cost savings in Dept. of Corrections for the HELP Act	4.8	19
Montana Developmental Center saving from SB 411 service level	4.0	39
Total potential lower expenditures	35.2	
2019 Expenditure Alternative Assumptions - impact structural balance		
Potential for Higher Reversions that could increase structural fund balance		
Medicaid caseload: lower than HB 2 budgeted continues	26.4	18
Medical cost savings in Dept. of Corrections for the HELP Act	4.8	19
Montana Developmental Center saving from SB 411 service level	8.0	39
Total potential lower expenditures	$39.2	

SUMMARY OF GENERAL FUND OUTLOOK

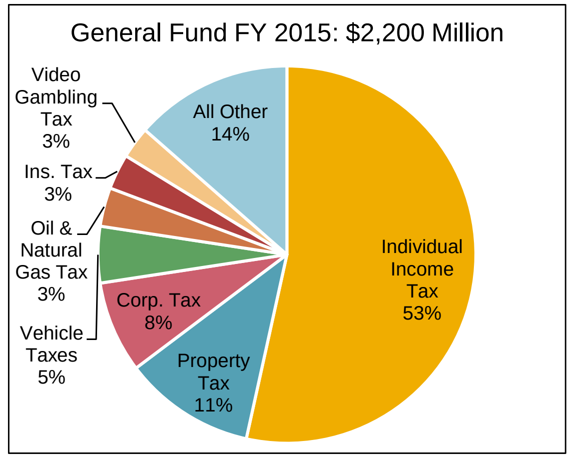
The general fund outlook is solid, though less strong than in recent years. Natural resource prices have impacted general fund revenue through lower severance and corporation income taxes, and the weak stock market growth has likely resulted in lower capital gains income and reduced individual income tax revenue collections. Expenditure pressures are typical, but the pressure to increase the ending fund balance has not been experienced recently. Alternative assumptions and other factors that could develop in the next six months may have a significant impact on the anticipated ending fund balance structural balance of the general fund.

REVENUE

Most general taxes are deposited in the state general fund. The general fund is used for most broad purposes of state government; education, health, and corrections are the predominant uses of this fund. Details of all general fund and most major state special fund revenue sources and allocations are contained in the Legislative Fiscal Division's 2017 Biennium Fiscal Report Volume 2.

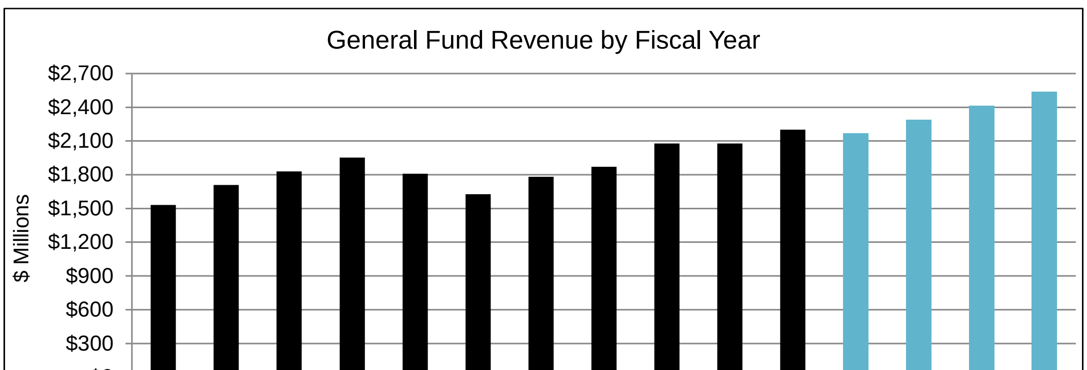
GENERAL FUND REVENUE SOURCES

The largest seven sources of general fund revenue are individual income tax, property tax, corporation income tax, oil and natural gas taxes, vehicle taxes, insurance tax, and video gambling tax. In FY 2015, these sources accounted for 86% of general fund revenue. Highlights of the top six tax sources are provided later in this section.



General fund revenue volatility is usually attributable to three sources: corporation income tax, and oil and natural gas production tax are quite volatile in relative terms, while small percentage swings individual income tax can produce significant changes to overall general fund revenue collections. More details on the revenue risk is provided in the Other Budget Considerations section of this report.

The chart below shows general fund revenue collections since FY 2005, with actual values shown in black and outlook values shown in light blue. The outlook for annual growth in general fund revenue for FY 2016 is -1.5%, FY 2017 is 5.6%, for FY 2018 is 5.5% and for FY 2019 is 5.2%.



	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
	1,531	1,708	1,830	1,954	1,808	1,627	1,783	1,871	2,078	2,077	2,200	2,166	2,287	2,412	2,538
%	10.8%	11.6%	7.1%	6.8%	-7.5%	-10.0	9.6%	5.0%	11.0%	0.0%	5.9%	-1.5%	5.6%	5.5%	5.2%

General Fund Revenue Outlook and Future Updates

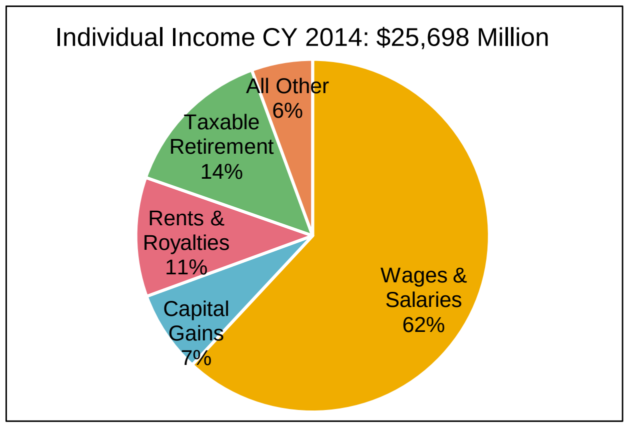
The general fund revenue outlook is produced by estimating the underlying sources of revenue and the economic drivers of those sources. Updated 2019 biennium revenue estimates for the general fund will be produced in November 2016 and presented to the Revenue & Transportation Interim Committee (RTIC). FY 2017 monthly revenue collections will be closely monitored throughout the 2017 Session. If significant differences occur between the FY 2017 estimate and the actual revenues received, updates will be provided to the legislature.

The following table summarizes the annual detail for the top seven general fund revenue sources and subtotal of the remaining sources.

General Fund Revenue Outlook Summary
($ Millions)

Source of Revenue	Actual FY 2015	Estimated FY 2016	Estimated FY 2017	Estimated FY 2018	Estimated FY 2019	Estimated 2017 Bien	Estimated 2019 Bien
Individual Income Tax	$1,175.7	$1,203.1	$1,284.2	$1,372.2	$1,462.4	$2,487.4	$2,834.6
Property Tax	247.9	257.8	260.8	274.6	281.3	518.6	555.9
Corporation Income Tax	172.7	121.7	156.4	163.5	171.2	278.2	334.7
Vehicle Taxes & Fees	106.4	110.5	114.3	113.1	114.8	224.8	227.9
Oil & Natural Gas Production Tax	73.2	51.8	46.7	49.2	52.4	98.5	101.6
Insurance Tax & License Fees	66.6	71.5	74.0	76.6	79.3	145.5	156.0
Video Gambling Tax	59.8	61.9	64.2	67.4	70.8	126.1	138.2
Remaining Sources	297.4	287.3	285.8	295.4	305.7	573.1	601.2
Total General Fund	$2,199.7	$2,165.7	$2,286.5	$2,412.0	$2,538.0	$4,452.2	$4,950.1

Individual Income Tax

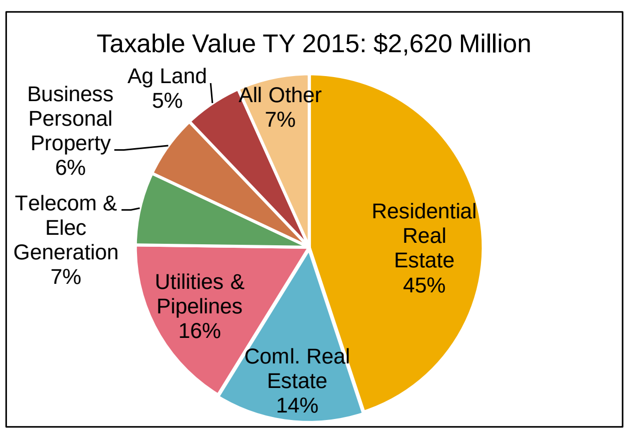


The individual income tax is levied against taxable income. The calculation for taxable income begins with the Federal Adjusted Gross Income. Several adjustments are made to produce Montana Adjusted Gross Income, and exemptions and deductions are subtracted to produce taxable income.

Tax rates vary from 1.0% to 6.9%, depending on the level of taxable income. The effective tax rate on capital gains income is less than the tax rate on ordinary income by 2%, after accounting for the 2% capital gains income tax credit.

The outlook for individual income in FY 2016 contains a -$24 million adjustment based on actual revenue collections through May. The downward adjustment is only included in FY 2016; if revenue trends continue, there would be a $25 million difference in FY 2017 and $55 million in the 2019 biennium.

Property Tax

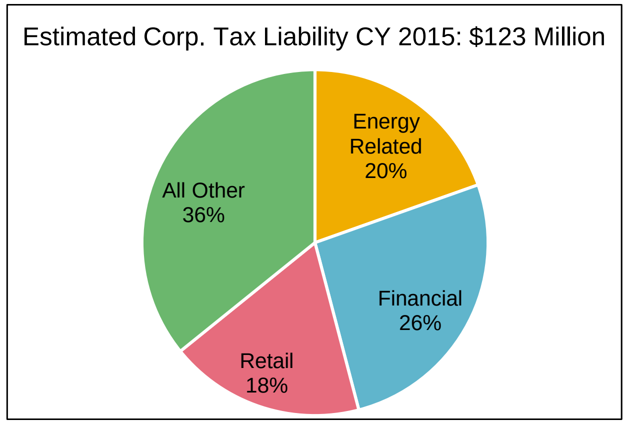


Montana law requires counties to levy a county equalization levy of 55 mills, a state equalization levy of 40 mills, and 6 mills for the university system against all taxable value in each county. A mill levy of 1.5 mills is also applied against all property in the five counties with a vocational technology (vo-tech) college (20-25-439, MCA). Taxable value is defined as the market value of statutorily defined property times a statutory tax rate.

SB 157 (2015 Session) changed agricultural land (Class 3), and residential and commercial land (Class 4) to a two-year reappraisal cycle from a six-year reappraisal cycle, while keeping timber land (class 10) on a six-year cycle. All other property classes are reappraised annually. The reappraisals are currently in process and will be the basis for FY 2016 property tax.

Corporate Income Tax

The corporation income tax is levied against a corporation's net income earned in or attributable to Montana, adjusted for allowable credits. The tax rate is 6.75%, except for corporations making a "water's edge" election (15-31-322, MCA), who pay a 7.0% tax on their net income.

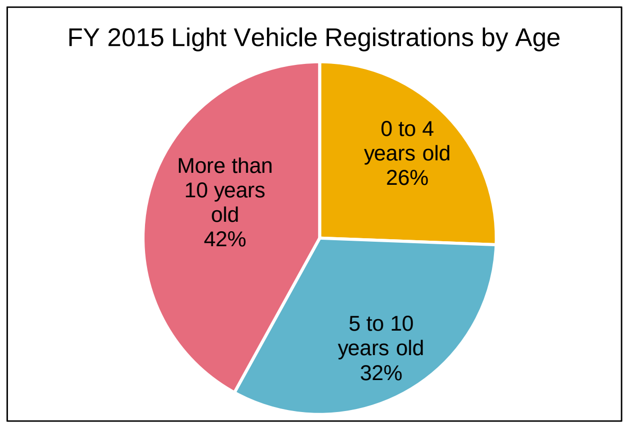


Financial and energy related sectors are the largest contributors to corporation income tax liability. Primary economic drivers of this source include oil prices, median house price, and retail sales. The forecast for this source is based on the rigorous statistical analysis by LFD.

The outlook for corporation income tax assumes that the large refunds already processed in FY 2016 will not be repeated in the forecast period.

Vehicle Taxes

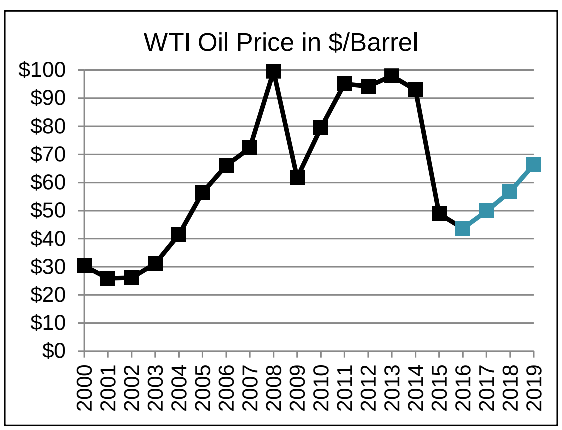
Revenue for this source is primarily generated by taxing light vehicles and a variety of other vehicles under a fee schedule that varies by age and weight. Light vehicles aged 0 to 4 years are taxed at $217; vehicles aged 5 to 10 years cost $87; and vehicles 11 years of age and older cost $28, although there is the option to permanently register them for $87.50.

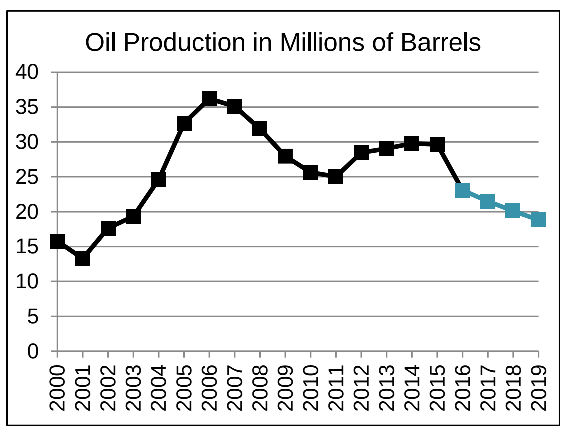


In addition, the state assesses a variety of motor vehicle fees such as fees for motor vehicle liens, fees for new license plates, and title fees.

Oil & Natural Gas Production Taxes

The oil and natural gas production tax is imposed on the production of petroleum and natural gas in the state. The gross taxable value of oil and natural gas production is based on the type of well and type of production, and whether the production occurs within the tax holiday. The charts below show the West Texas Intermediate (WTI) oil price and Montana production.





The outlook for oil production tax assumes declining production and steadily increasing prices. Oil production taxes could be different than forecast if prices are materially different than assumed in the forecast. Changes to productions assumptions would have little revenue impact in the 2019 biennium due to the oil tax holiday for newly completed wells.

Insurance Tax

The majority of insurance tax revenue comes from a tax of 2.75% on net premiums sold. There is an additional 2.5% levied on fire insurance premiums sold, and a number of small fees. The general fund portion is made up of 100% of fire insurance taxes, 95% of captive insurance taxes, and 67% of all other premium taxes, as well as a fraction of the fees.

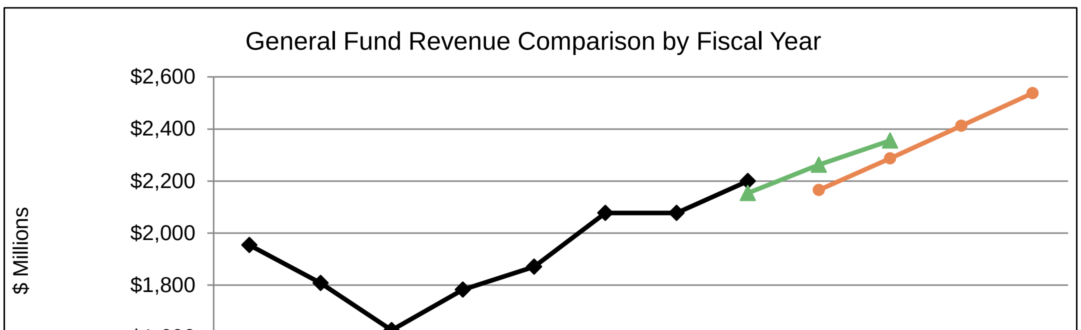
The majority of the insurance types contributing to this source are growing at a steady rate, while health insurance is currently growing more rapidly. This growth is primarily due to increases in the number of health insurance premiums associated with implementation of the Affordable Care Act, in addition to fluctuations in premium increases allowed by the State Auditor.

Remaining Sources

The outlook for video gambling tax and all remaining sources is generally positive, with higher interest rates and growth in consumption outweighing the declines related to natural resource extraction and the closure of the Montana Developmental Center.

Summary and Comparison to the Official Estimate in HJ 2

Updated 2019 biennium revenue estimates for the general fund will be produced in November 2016. The estimates will be updated throughout the 2017 legislative session using a monthly review of year-to-date revenue collections and updating models with new economic data from IHS and other sources. The comparison chart below highlights the difference between the current outlook and official estimate contained in HJ 2.



	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Actual	1,954	1,808	1,627	1,783	1,871	2,078	2,077	2,200				
2015 HJ2								2,154	2,263	2,355		
2019 Outlook									2,166	2,287	2,412	2,538

Extended Outlook

Based on current data and econometric forecasts, the extended forecast for the 2021 biennium suggests general fund revenue growth of 5.7% in FY 2020 and 4.7% in FY 2021.

EXPENDITURES

General fund present law expenditures in the 2019 biennium are projected to total $4.844 billion, an increase of $242 million from the FY 2017 ongoing appropriation level. Appropriations are comprised of HB 2, statutory appropriations, non-budgeted transfers and other bills. The following figure summarizes the adjustments made to each source of appropriation authority, which are explained further in the report. The two year increase is measured by calculating the increase between each estimated year and the FY 2017 appropriations, and adding the two values together.

Change in Appropriations from FY 2017

($ Millions)

	FY 2017 Appropriated	FY 2018 Estimated	FY 2019 Estimated	Two Year Increase
HB 2 General Appropriations Act	$1,984.2	$2,066.1	$2,091.8	$189.4
Statutory Apporpriations	288.3	312.5	324.9	60.7
Non-budgeted	20.3	19.4	18.6	(2.6)
Other	8.5	2.3	9.3	(5.4)
Total	$2,301.3	$2,400.2	$2,444.6	$242.2

STATUTORY APPROPRIATIONS

Statutory appropriations are in law and are not part of the biennial budgeting process. Statutory appropriations comprise approximately 13% of all general fund expenditures or $637 million in the biennium. This is a biennial increase of $61 million over the FY 2017 level. The increases are predominantly due to the Montana HELP Act, projected increases in local government entitlement share payments, and pension contributions. Statutory appropriations are dominated by four types of expenditures:

- Entitlement share payments to local governments are 43% of total statutory appropriations or $278 million in the biennium and are $12 million of the growth in statutory appropriations from the FY 2017 level
- Payments for employee, local fire, police, and teacher retirement costs are 37% of statutory appropriations or $235 million in the biennium and are $15 million of the growth in statutory appropriations from the FY 2017 level
- SB 405 Montana Health and Economic Livelihood Partnership (HELP) Act (Medicaid expansion) 11% of statutory appropriations or $69.7 million in the biennium and are $36 million of the growth in statutory appropriations from the FY 2017 level
- Debt service payments are 3% of total statutory appropriations or $21 million in the biennium and reduces the growth in statutory appropriations by $3 million due to the payoff of certain bonds

NON-BUDGETED TRANSFERS

The majority of non-budgeted transfers are vehicle revenues distributed to various state special revenues funds and Old Fund (State Fund) liabilities. Non-budgeted transfers in the 2017 biennium are anticipated to be higher than projected during the 2015 Session. Old Fund liability transfers were anticipated to be less in each year of the 2017 biennium, but instead, the 2017 biennium is estimated to be higher due to the additional number of settlements and more costly asbestos claims than originally planned.

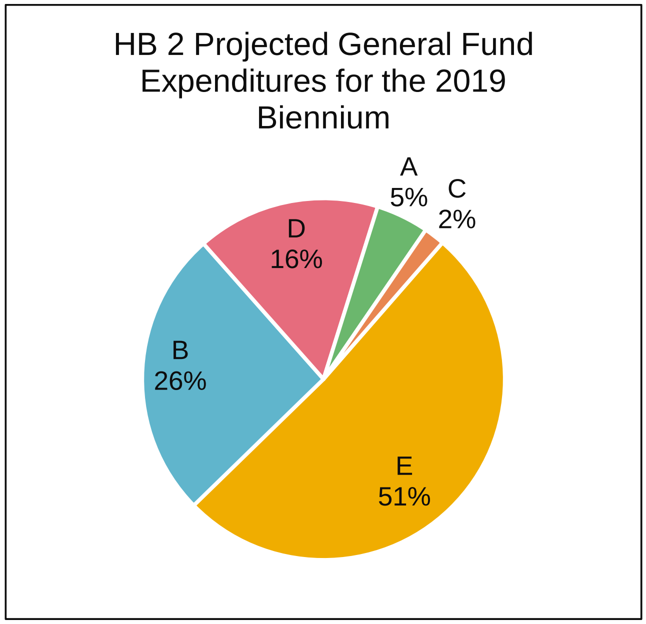
Non-budgeted transfers are projected to decline in the 2019 biennium. Reduced distributions to Old Fund, noxious weeds, junk vehicles and boating facilities and enforcement account for the anticipated decline of about $1 million in each year of the 2019 biennium from the FY 2017 projection.

HB 2 General Appropriations Act

HB 2, the General Appropriations Act, is the primary source of appropriations for state general fund. The budget for the 2019 biennium present law largely reflect the budget approved by the previous legislature.

The HB 2 expenditure projections for the 2019 biennium for present law obligations are $189 million higher than the FY 2017 level. This estimate increases FY 2018 by 4.1% and FY 2019 by an additional 1.2%. The key areas of increase include:

- $71 million in reestablishing the FY 2017 appropriation level for the Office of Public Defender and the Department of Livestock
- $48 million in additional costs for K-12 school district funding
- $22 million in increased Medicaid utilization and caseload increases, which is lower than normal as some individuals were transitioned into the expansion population, which is funded statutorily
- $21 million of increases for statewide assumptions such as annualizing state employee pay, inflation, deflation and fixed costs



As illustrated in the HB 2 pie chart, 93% of all HB 2 projected general fund expenditures are made in three areas:

- Section E - Education: consisting of both the Office of Public Instruction (K-12 education) and the Commissioner of Higher Education – 51%
- Section B - Department of Health and Human Services (DPHHS) – 26%
- Section D - totals 16% with the Department of Corrections being 10% (remaining Section D Department of Justice, the Judiciary, and Office of Public Defender 6%)

The following discussion provides additional details regarding the assumptions used in the above calculations.

Assumptions for HB 2 Expenditures

General Adjustments

General adjustments to the budgets of all agencies include:

- Annualization of the pay plan provided in HB 2, statutory increases in the employer contribution for the Montana Public Employee Retirement System, elected official pay adjustments and a stepped-in adjustment for health benefits which totaled to $17 million for two years
- Fixed costs and inflations totaled $2 million general fund
  - Various changes for fixed costs, which were based on historical usage trends, current fund balance, and possible future costs
  - Inflation on various operating costs were forecast using the IHS projections
- Inclusion of estimated legislative audit costs from a base level in FY 2017 of zero to $2 million general fund for the biennium

The total general fund adjustment for all these factors is $21 million for the 2019 biennium.

Specific Adjustments to Agency Budgets

Section A – General Government

No large general fund increases for present law were included in the Section A budget. Increases in proprietary rates and small increases that impact all agency budgets are included in fixed cost increases.

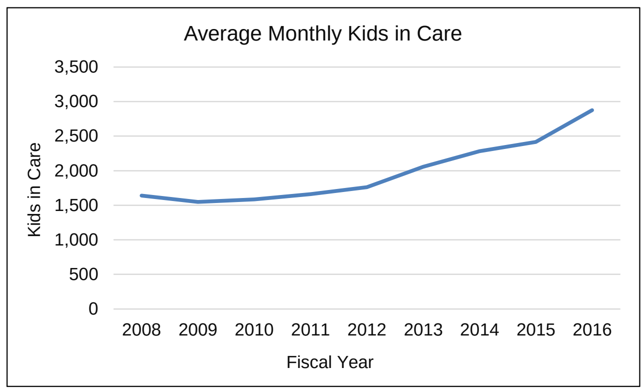
Section B – Department of Health and Human Services

The 2019 biennium outlook includes general fund present law adjustments other than pay and benefits that total to a $31 million general fund increase for the Department of Health and Human Services (DPHHS). Factors that contribute to the general fund increase for the two years include:

- Medicaid expenditures traditionally grow annually at a rate averaging 6.6% nationally. This is the cumulative effect of increased enrollment, provider rate increases, service utilization, and medical inflation. The general fund growth due to these present law changes totals $22 million. (For a basic introduction to Medicaid, click here to view our "Medicaid 101" primer)
- Personal services increase of $3.8 million for hourly wage, benefits, insurance, and retirement per HB 454 (included in the general adjustments discussed on page 17)
- Statutory physician and psychiatrist provider rate increases of $0.2 million
- Child and Family Services caseload increase for foster care and other placement options for children in in need of care $4.8 million

Children and Family Services Division

The Child and Family Services Division (CFSD) has been experiencing unprecedented growth in the number of kids in care over the last few years. Caseloads were at a recent low monthly average of 1,548 kids in FY 2009, and have grown to a monthly average of 2,876 to date in FY 2016. The number of kids in care has increased in every month of FY 2016 from 2,664 in July to 3,179 in April, so the caseload growth shows no signs of slowing. The chart to the right illustrates this growth, which started accelerating around FY 2013 and has continued to accelerate in FY 2016.



The caseload addressed above references only kids in foster care. Montana also subsidizes some adoptions and permanent guardianship placements, there is also growth in these cases as children move through foster care to permanent placements. Forecast caseloads in this report assume that growth will continue at its current pace.

This report assumes a continued rate of growth for subsidized guardianship of 19% per year from the FY 2017 appropriation. Subsidized adoption is assumed to grow at 5% annually, and foster care at 10% (5% for Title IV-E cases which have been experiencing slower growth). Based on growth so far in FY 2016, there is a risk that these growth rates may be low.

The total general fund impact of this growth is about $4.8 million for the 2019 biennium.

Alternative Assumption

Current Medicaid benefit expenditure trends suggest that the 2017 biennium expenditures may be $26.4 million less than budgeted in HB 2. Looking beyond FY 2017, the Legislative Fiscal Division Medicaid projection suggests Medicaid will grow in FY 2018 and FY 2019 by approximately $22.4 million for the

2019 biennium, from the currently projected FY 2017 levels. However, as DPHHS has the flexibility to use the entire budget amount in other areas, and has indicated it will do so with the majority of the difference in FY 2016, this outlook assumes the budgeted growth will be on top of current base budget levels, rather than from the reduced level of FY 2017 Medicaid benefits expected.

Section D – Judicial Branch, Law Enforcement and Justice

Department of Corrections

The Department of Corrections is currently experiencing budget challenges in paying for the level of inmates held in county jails. The Department was budgeted for 250 inmates in county jails and is currently paying to hold 375 inmates in county jails. The additional budget pressure from these additional inmates is $2.5 million per year. While the agency is working to manage within the current 2017 biennium budget, it is anticipated that the additional $2.5 million will be a present law request of the department.

Caseload increases for the Department of Corrections are typically new proposals due to the inherent policy decisions that must be made as the state grows its inmate, probation, and parole populations. As a result of these policy choices, these estimated increases are shown in the budget pressures section on page 23.

Alternative Assumption

- Department of Justice: Higher than Anticipated Costs for Medical Examiners
  Turnover in medical examiners function of the department has resulted in higher than budgeted costs in the Forensic Services Division. A funding shortfall in FY 2016 led to an estimated $0.8 million shortfall for the FY 2017 biennium. The impact may continue into the 2019 biennium

- Office of Public Defender: Caseload Higher than Anticipated
  Caseload growth dominated by dependent and neglect cases are higher than anticipated. This will result in a supplemental funding position in the 2017 biennium of projected $3.5 million. The impact to higher caseload growth will continue into the 2019 biennium

- Department of Corrections
  - County Jail Holds - As described above, the department is experiencing shortfalls for funding county jail holds in the 2017 biennium and may require a supplemental of up to $5.0 million

  - Medical Cost Savings in Department of Corrections - When the Montana Health and Economic Livelihood Partnership (HELP) Act was passed by the 2015 Legislature, it was assumed that the department would realize savings in general fund for outside medical costs as inmates transition to Medicaid. The estimated savings was about $5 million each biennium. As a result, the Department of Corrections medical budget was restricted to use for medical costs. Year-to-date information indicates that savings is being generated within the medical budget of the Department of Correction

Section E – Education and Cultural

Office of Public Instruction

General fund to support K-12 education is forecast to increase by $48.3 million for the 2019 biennium.

1.	Increases due to inflation	$29.8 million
2.	Projected increase in Enrollment	$ 4.4 million

3. Projected Increase in Natural Resource Development (NRD) Payment $ 3.2 million[2]
4. Projected decrease in guarantee account to offset general fund $11.0 million

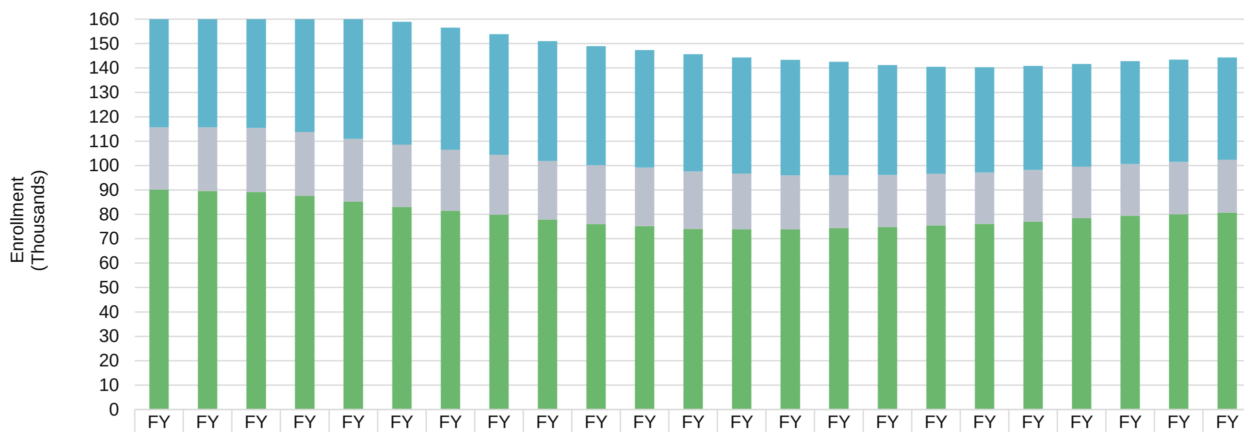
K-12 education is funded by state and local sources[3]. School districts' general fund budgets are the primary fund to which state appropriations contribute. Funding from the state includes the guarantee account and general fund; local sources include local tax revenue, non-levy revenues, and any balances remaining from the previous year.

Revenues into the guarantee account are comprised of interest from the cash portion of the school trust and income from common schools trust land. The primary sources of the income portion of the funding are leases for agriculture and other natural resources such as timber, oil, and coal.

A school funding formula is used to determine the level of funding. Changes in funding levels depend primarily on statutorily defined inflation and on enrollment increases.

Projections for enrollment are based on the most recent Office of Public Instruction forecast of an increase of 0.7% in FY 2018 and 1.0% in FY 2019. Enrollment increases are estimated to increase funding levels by $4.4 million

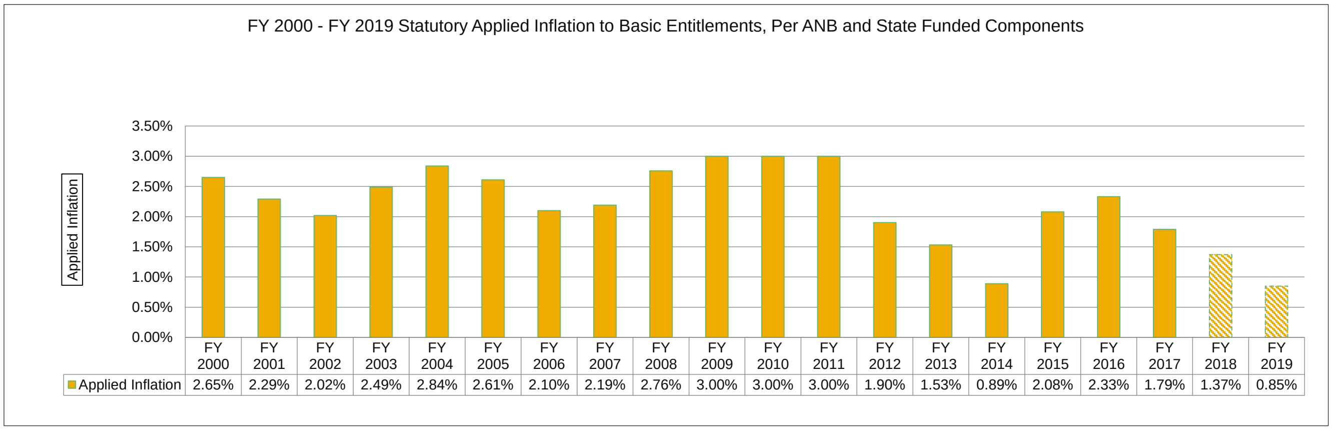
Montana Public School Enrollment
(Thousands of Students)



	FY 1994	FY 1995	FY 1996	FY 1997	FY 1998	FY 1999	FY 2000	FY 2001	FY 2002	FY 2003	FY 2004	FY 2005	FY 2006	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011	FY 2012	FY 2013	FY 2014	FY 2015	FY 2016
Total Enrollment	162.0	163.3	164.6	163.6	161.3	159.0	156.5	153.9	151.0	148.9	147.4	145.7	144.3	143.3	142.6	141.2	140.5	140.3	140.8	141.7	142.8	143.4	144.3
High School	46.3	47.6	49.1	49.9	50.3	50.4	50.0	49.6	49.1	48.8	48.2	48.1	47.6	47.4	46.5	45.0	43.9	43.2	42.6	42.1	42.2	41.9	41.9
Middle	25.6	26.1	26.3	26.1	25.8	25.5	25.1	24.5	24.1	24.2	23.9	23.6	22.9	22.1	21.7	21.4	21.2	21.0	21.3	21.2	21.2	21.5	21.7
Elementary	90.1	89.6	89.1	87.6	85.2	83.1	81.4	79.9	77.8	76.0	75.2	74.0	73.8	73.9	74.4	74.8	75.4	76.1	77.0	78.4	79.4	80.1	80.7

Statute requires that certain components of school funding include a present law adjustment for inflation in the superintendent's budget request (20-9-326, MCA). Anticipated inflationary increases in the 2019 biennium are 1.37% in FY 2018 and 0.85% in FY 2019. This growth rate is lower than the previous biennium growth rates of 2.33% in FY 2016 and 1.79% in FY 2017. Inflation is expected to increase funding levels by $29.8 million.

[2] NRD payments increase over base year by, $2.4 million in FY 2018 and $4.4 million in FY 2019 ($6.8 million total), this increase is offset by $3.6 million in GTB savings. Net increase is $3.2 million.
[3] School districts also receive federal funds which are not discussed in this report



	FY 2000	FY 2001	FY 2002	FY 2003	FY 2004	FY 2005	FY 2006	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011	FY 2012	FY 2013	FY 2014	FY 2015	FY 2016	FY 2017	FY 2018	FY 2019
Applied Inflation	2.65%	2.29%	2.02%	2.49%	2.84%	2.61%	2.10%	2.19%	2.76%	3.00%	3.00%	3.00%	1.90%	1.53%	0.89%	2.08%	2.33%	1.79%	1.37%	0.85%

The forecast included in the outlook contains increases for enrollments, inflation, and forecasted revenues into the guarantee account. Guarantee account revenues are anticipated to be $43.5 million in FY 2018 and $44.2 million in FY 2019. Compared to the base year this is a decrease of $5.9 million in the first year of the biennium, and $5.1 in the second year ($11 million for the biennium) primarily due to the loss of oil bonus payments. Since the guarantee account offsets the need for general fund to support BASE Aid, this drop in anticipated revenue will increase the need for general fund.

Office of the Commissioner of Higher Education

The primary funding source of the Montana University System (MUS) is known as the current unrestricted fund which is supported with state general fund, the statewide 6 mill levy, and tuition and fees. The Board of Regents controls the level of tuition and fees, while the legislature appropriates the 6 mill levy and general fund. During some sessions, agreements on the level of funding and tuition increases between the legislature, the Governor, and the Regents can be established. Resident-student tuition was capped during the 2017 biennium as part of an agreement between the Governor, the Board of Regents, and the 2015 Legislature.

The following items were considered in developing the MUS present law level of funding:

- A significant factor for the MUS campuses' budgets is enrollment. For the 2019 biennium, the Office of the Commissioner for Higher Education has stated that while changes in the mixture between in-state and out of state enrollment may occur at various campuses, enrollment across the system is anticipated to decrease slightly. The MUS present law adjustment does not assume a reduction in funding for the anticipated decrease in enrollment
- Recent budget issues primarily impacting the University of Montana – Missoula have affected the FY 2017 base budget, reducing the campus' current unrestricted fund by 192 FTE. This adjustment will result in a reduced level of Regents allocated state support to the University of Montana going into the 2019 biennium
- The only adjustments included in the MUS present law in this outlook are for personal service annualization and inflation and is based upon 2017 biennium general fund ratio. The increases total $4.5 million in the biennium. This funding ratio would require a tuition increase to fund the tuition share of the increased costs

GENERAL FUND BUDGET PRESSURES

When establishing the estimate of present law contained in the 2019 Biennium Outlook, LFD staff adhered to present law as defined by statute as that level of funding needed under present law to maintain operations and services at the level authorized by the previous legislature.

EXPENDITURE PRESSURES

As introduced on page seven, the following table shows the pressures that are further described in this section of the Outlook.

General Fund Pressures
($ Millions)

	Minimum	Potential	Page
Agency Pressures			
Office of the Public Defender - Caseload increases	$4.8	$5.8	23
Department of Corrections - Caseloads in all areas	11.8	11.8	23
Department of Corrections - County jail rate pressure	1.7	3.0	23
DPHHS - Additional Federal waiver for Developmental Disabilities Services	2.4	2.4	23
DPHHS - Protect Montana Kids Initiative	1.0	1.5	23
Natural Resource revenue shortfall backfill with general fund	2.5	5.8	23
Judicial Branch - additional district court judges	-	2.3	24
K-12 Funding Study: waiting for Commission recommendations	-	-	24
Current Service Level: services funding with one-time appropriations			
Aquatic Invasive Species	1.0	1.9	25
Office of Public Instruction - Montana Digital Academy	0.8	1.7	25
Department of Administration - State Facilities Maintenance of Common Areas	1.6	3.3	25
Department of Commerce - Indian Country Economic Development	0.8	1.6	25
Department of Commerce - Tribal language	0.8	1.5	25
Department of Corrections - Lewistown Infirmary and Women's Prison	0.6	1.1	25
Judicial Branch - Information technology staff	0.2	0.4	25
Inflationary items: Provider Rate Increases (1% - 3%)			
Department of Public Health & Human Services (DPHHS)	10.9	32.7	26
Department of Corrections	1.6	4.8	26
Office of Public Defender	0.2	0.6	26
Inflationary items: Pay increases for state employees (pay plan) (1% - 3%)	14.0	42.1	26
Mitigating tuition increases for inflationary items for the Montana University System	-	12.8	26
State and Local Infrastructure			
State infrastructure historical level of general fund transfers	-	40.0	27
State Information Technology Infrastructure historical level of transfers	-	10.0	27
Local infrastructure grants such as Treasure State Endowment Grants	1.0	14.3	27
School Facility shortfall in revenue (includes school facility debt service)	4.8	21.6	28
Highway state special revenue fund shortfall	-	32.4	29
Total Pressures	$62.4	$255.4	

Agency Pressures

Office of Public Defender - caseload

The Office of Public Defender continues to have caseload growth as pressure from a criminal and dependent neglect cases increase. The estimate of $4.8 million is the historical growth rate pattern in the past five years.

In addition, no funding currently exists in the present law budget for defense in capital (death penalty) cases. Although no cases have been declared by the state as a capital penalty case, the office has expended about $100,000 on cases where the prosecution has indicated they may seek the death penalty. In previous biennia the legislature has provided restricted and one-time-only (OTO) funding of $1.0 million to fund capital defense. With the possibility that a prosecutor may seek the death penalty the legislature may encounter pressures to fund capital defense.

Department of Corrections - caseload

The Department of Correction has had an average annual growth in offender population of 2.2%. Applying this historical growth to the 2019 biennium results in an anticipated growth of $11.8 million in the 2019 biennium.

Department of Corrections – County Jail Rates

The 2015 Legislature capped rates that the state pays for housing state responsible offenders in county jails at $69 per bed-day. The legislature may encounter pressures to restore the funding to the level corresponding to the rates prior to the cap. The estimate for this increase was derived from the negotiated rates prior to the cap and results in a biennial pressure of $1.7 to 3 million.

Department of Health and Human Services – Additional federal waiver for Developmental Disabilities Services

The SB 411 Council recommends creation of a new waiver called “waiver 2” to serve 50 individuals with higher acuity at an estimated annual cost of $4.0 million as part of a broader plan to serve more Montanans with developmental disabilities in the community. Approximately $2.4 million in general fund will be required for the biennium. This assumes that the reduction of $2.8 million in the Developmental Services Division, as required by SB 411, will occur in the Montana Developmental Center budget and also removes the council’s recommended $1.6 million OTO for facility modifications taken in FY 17.

Department of Health and Human Services – Protect Montana Kids Initiative

The Governor implemented a series of actions intended to address the growth in Child and Family Services Division caseload. This included an executive order establishing the Protect Montana Kids Commission, and the creation of 42.50 modified FTE. There is expected to be pressure to fund 30.00 FTE that were created in FY 2016 utilizing vacancy savings.

Natural Resource Revenue Shortfalls

Due to the decreased revenues from oil & gas sources, cash flow to the Resource Indemnity Trust related accounts will be impacted. The scope of this includes Natural Resource Operations, Natural Resource Projects, Environmental Contingency, Orphan Share, and others. At this time, the LFD has difficulties estimating the exact size of the impact and where it will land. Possibilities to address the shortfalls other than curtailing services include accessing other available state special revenue sources or cost shifting to the general fund.

Given current revenue forecasts, the Hazardous Waste, Ground Water, Orphan Share, and Natural Resource Operations funds will all be impaired. These following funds support services within the Department of Natural Resource and Conservation (DNRC), Department of Environmental Quality (DEQ), and the Bureau of Mines:

- Hazardous Waste/CERCLA – supporting administration of the state's hazardous waste program
- Ground Water Assessment– supporting ground water characterization and monitoring at the Bureau of Mines
- Orphan Share - supporting remediation of property where no liable party exists
- Natural Resource Operations – supporting administration of natural resources including programs in the Bureau of Mines, the Department of Natural Resources and Conservation, and the Department of Environmental Quality

In addition, decreased coal revenues are expected to create shortfalls within the coal shared account and services funded by the resource indemnity and groundwater assessment (RIGWA) tax will likely be affected as well. The Montana Growth through Agriculture program, Conservation Districts, and State Library Commission are already being affected by decreased coal revenues as their budgets have been reduced. The estimated shortfalls created by each of the mentioned revenue sources and the affected agencies are shown in the table below:

2019 Biennium Shortfall in Natural Resource Revenue Accounts		
Revenue Source	Anticipated Shortfall	Agencies Impacted
Coal Severance Tax Shared Account	$1,342,418	Library/Agriculture/DNRC
Oil & Natural Gas/Metal Mines	3,618,460	DEQ/DNRC/Bureau of Mines
RIGWA	819,026	DEQ/ Bureau of Mines
Total Shortfall	$5,779,904	

For more information regarding natural resource tax revenue please see page 32.

Judicial Branch – additional judges

The Judicial Branch regularly conducts a weighed caseload study to determine judicial resource needs. The most recent study, conducted by the National Center for State Courts, found that 17.63 judges would be needed to address caseloads of Montana district courts. The district court council has indicated that it would seek to add five judges and one standing master along with minimum staffing to support these judges and standing master. The estimated 2019 biennium cost, based on the council's implementation plan, is $2.3 million and a cost of $ 4.1 million biennium cost when fully implemented.

K-12 School Commission Recommendations

The School Funding Interim Commission established under SB 128 (2015 Session) will hold its next meeting of the interim on Monday, June 13. More information is provided on the committee webpage: http://leg.mt.gov/css/Committees/Interim/2015-2016/School-Funding/default.asp

The commission's work is often referred to as "the decennial study" as it fulfills a statutory requirement that Montana's K-12 school funding formula be reviewed at least every ten years. The 16 commission members (12 legislators and four public members) are tasked with reassessing the needs and costs related to the basic system of free quality public elementary and secondary schools, and if necessary recommending changes to the state's funding formula to the 65th Legislature.

At this time the commission has not voted on recommendations and no dollar amounts have been added to the pressures. However potential pressures emerging from commission discussions include:

- Increasing Special Education payments
- Increasing funding for debt service guaranteed tax base (school facility debt reimbursement)
- Creating and funding a new facility grant program

Current Service Level

Current service level refers to OTO appropriations that the legislature may be under pressure to maintain in order for the level of services offered by the state to continue. Often these are linked to OTO appropriations that have been funded for several biennia. Alternatively, the legislature may have authorized the appropriation as an OTO in order to trial a new or changed program.

The current service level items total $11.5 million for the 2019 biennium. The following briefly describes each item:

Aquatic Invasive Species

The Legislature has provided one-time funding to prevent the spread of aquatic invasive species. In the 2017 Biennium, $1.9 million was provided in one-time and is anticipated to be requested to be funding again in the 2019 biennium.

Montana Digital Academy (MTDA)

The MTDA has a base budget of $1,168,000. The 2015 Legislature provided OTO appropriations of $832,500 in each year of the 2017 biennium. The continuation of the one-time appropriations would cost $1.7 million general fund.

Department of Administration – State Facility Maintenance Common Areas

The 2017 biennium provided one-time only appropriations for the maintenance of common areas in state buildings, like much of the Capitol building. The continuation of these appropriations would cost $3.3 million general fund.

Department of Commerce - Indian Country Economic Development

The Indian Country Economic Development Program has been funded through OTO appropriations for several biennia. This program has been appropriated $0.8 million in general fund each fiscal year since FY 2012. It is anticipated that the current service level adjustment for the 2019 biennium for the Indian Country Economic will be $1.6 million.

Native Language Preservation

The Native Language Preservation Program documents and preserves languages for various tribes in Montana. The program was established and has been funded through OTO appropriations since the 2015 biennium. Appropriations were $1.75 million in FY 2014 and $0.75 million in FY 2015, FY 2016 and FY 2017. Expenditures in FY 2015 were approximately $0.75 million and are expected to reach $0.75 million in FY 2016. It is anticipated that the current service level adjustment will be $1.5 million for the 2019 biennium.

Department of Corrections – Lewistown Infirmary and Women's Prison

The 2015 Legislature funded FTE that function as security for the Lewistown Infirmary and medical staff for the Montana Women's' Prison as one-time-only. Since the functions performed by these FTE are of an ongoing nature, the legislature may experience pressures to fund them in the 2019 biennium at a biennial cost of $1.1 million.

Judicial Branch

The 2013 and 2015 Legislatures funded requests for information technology staff as one-time-only even though the staff would support information technology systems of the branch that are ongoing in nature. The 2017 Legislature may face a pressure to fund these positions. The biennium cost to fund these is about $420,000.

Inflationary Item - Provider Rate Increase

The vast majority of medical and community services administered by the Departments of Public Health and Human Services (DPHHS) and Corrections are provided through contracts with private businesses. In some instances, the state agency is the primary or only customer for these services. As business entities or private non-profits, contractors are subject to the same economic conditions as other employers. These businesses traditionally request that the legislature consider rate increases to cover cost growth and to maintain operations.

Provider rate increases in the past have ranged from 0% to 5% for selected providers. A 1% annual rate increase is estimated to cost $12.7 million general fund as follows:

- $10.9 million for Department of Public Health and Human Services
- $1.6 million Department of Corrections
- $0.2 million for the Office of State Public Defender

A 3% annual rate increase for all providers is estimated to cost $38.1 million general fund over the 2019 biennium.

Inflationary Item – State Employee Pay

State employee pay increases are generally but not always approved by the legislature in pay plan legislation. In the past ten years, pay plans have ranged from 0% to 3.6% per year for salary increases and 0% to 10% per year for insurance contribution increases. A 1% annual rate increase is estimated to cost $14.0 million general fund as follows:

Non Montana University System

- Pay and salary related benefits - $9.3 million
- Health insurance - $2.0 million

Montana University System – funded at the FY 2017 funding ratio

- Pay and salary related benefits - $2.3 million
- Health insurance - $0.4 million

A 3% annual rate increase is estimated to cost $42.1 million in general fund over the biennium.

MUS Tuition

If the legislature limits tuition increases within MUS, the Board of Regents (BOR) may request additional state support for pay plan and inflationary adjustments. To fully eliminate a tuition increase the BOR may request full resident and WUE student share funding, an increase from the current level of 39.9% general fund support for the current unrestricted fund to 79.7% general fund. Using a 1% pay plan increase over the biennium, general fund would increase by $7.4 million. A 3% pay plan results in an additional $12.8 million.

State and Local Infrastructure Programs

The Long-Range Planning (LRP) programs include many of the state's infrastructure funding programs. LRP programs are funded with dedicated revenue streams, which in effect provides the spending parameters. The dedicated revenues for these programs consist in large part of extraction taxes. With declines expected in the coal severance tax and oil and natural gas tax, some of these programs are projected to experience reduced program funding. The early projections for several of the significant LRP programs include:

Long-Range Building Program (LRBP)

In the 2017 biennium, the coal severance was expected to provide 42% of the total program revenues (net of the debt service obligations of the LRBP fund). Total revenues for the 2017 biennium are expected in preliminary estimates to be approximately 16% less than projected in the 2015 Legislative

Session and the reduction is expected to continue through the 2019 biennium. While the dedicated revenue steam is projected to be less, the costs of debt service paid from the LRBP fund is projected to be significantly reduced in the 2019 biennium, offsetting the reduction in revenues, and providing approximately the same level of funding for projects in the 2019 biennium. Over the past five biennia, the LRBP budget has included transfers averaging $40.0 million from the general fund to increase funding for projects. In the 2019 biennium there could be pressure to increase projects again.

Long Range IT - Long-Range Information Technology Program (LRITP)

The LRITP does not have a dedicated revenue source to fund projects. Instead, general fund transfers into the program are provided to fund projects in general fund supported agencies. While there are not revenue declines that would impact this program, there is likely to be a general fund pressure for general fund supported agency projects. The biennial average of general fund transfers provided in the last five biennia is $16.9 million, but that average includes biennial transfers amounting to $43.8 million in the first biennium of the program, 2009. Omitting those unusually large transfers, the average biennial transfer has leveled off at approximately $10.0 million per biennium and increasing pressures to the general fund by a like amount.

Local Infrastructure and Natural Resource Grants

Over the past five biennia, the local infrastructure and natural resource grants budgets has included transfers averaging $13.3 million from the general fund to increase funding for projects. In the 2019 biennium there could be pressure to fund more projects again.

DNRC Grant Programs

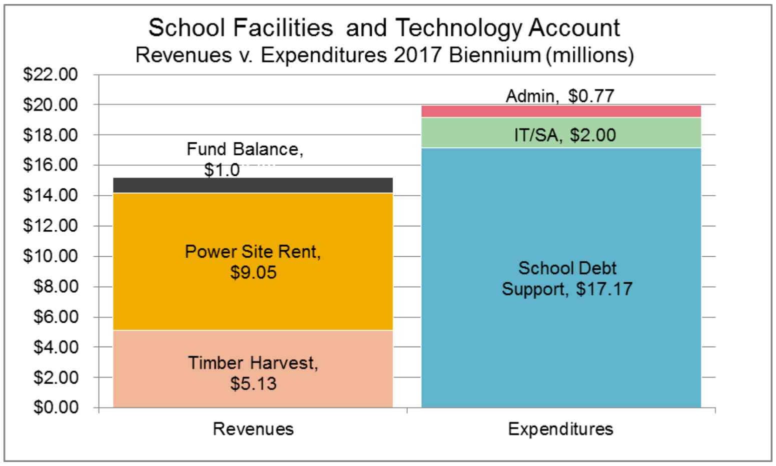
The DNRC grant programs, which includes the Renewable Resource Grant Program and the Reclamation and Development Grant Program, were expected to receive over 30% of their grant funding in the 2017 biennium from oil and natural gas taxes. Total revenues for the natural resource projects account, which funds the grant programs, are expected to be 11.4% less than was expected during the session and early projections show revenues for the account being 9.6% less in the 2019 biennium than last session. As a result, there will be approximately $1.0 million less revenue for the appropriation of projects in the grants programs.

Treasure State

The early projections for infrastructure programs reliant on interest earnings, Treasure-State Endowment Program (TSEP) and the Treasure State Regional Water Program (TSEPRW), are expected to be unchanged in the 2019 biennium, supporting a similar amount of grants.

School Facilities

Since FY 2012, the school facilities and technology state special revenue account has been the primary source of state funding assistance for K-12 facilities. Last session the revenues of the account were not sufficient to support all the state school infrastructure functions, which include:



- State reimbursement for school district bonded debt ($17 million), MCA 20-9-371;
- Payment of statutory appropriations for school technology ($2 million), MCA 20-9-534; and
- Quality Schools Program administration ($765,070), MCA 90-6-809.

Given the projected shortfall in funding, the 2015 Legislature did not appropriate grant funding for the Quality Schools Facilities Grants Program (quality schools). Additionally, appropriations provided in the 2015 Legislative Session exceed the anticipated account revenues in the 2017 biennium by approximately $4.8 million.

The account commitments outlined above are established in law, which requires that certain functions, specifically the quality school grant application process, are conducted and driving the need for administrative support. In past years, the quality schools program grant funding has been approximately $14 million.

The state reimbursement of school debt has not been fully funded in the past two biennia. In the 2017 biennium, the school debt support was appropriated at 86% of the formulated amount of $10 million. Full funding of the state debt support would require a funding increase of $1.4 million.

The account receives transfers of certain revenues from the school guarantee account which are estimated to be approximately $15.2 million in the 2017 biennium. Funding for the 2019 biennium is expected to be the same. Assuming the same level of appropriation in the 2019 biennium, correcting for the funding shortfall ($2.4 million/year), adding funding for the grant program ($7.0 million/year), and fully funding the school debt reimbursement ($1.4 million/year), the total funding pressure estimated for the school facility and technology fund is $21.6 million for the biennium.

One of the major revenue sources for the school facility and technology account is power site rents, rental charges for dam sites located in state-titled riverbeds. Initially, the state expected to receive substantial revenues through the power site rentals. However, in 2004 litigation began contesting the state's right to collect these fees. Two of the three companies involved in this litigation entered into settlement agreements and leases to resolve their disputes with the state, whereas the third company chose to continue to litigate the matter. Currently this case is before Federal District Court for the District of Montana. Until this litigation is resolved, no definitive upside or downside projection of the risks associated with state hydropower site rental revenues can be made.

State assistance with K-12 facilities was a topic of analysis in the School Funding Commission during the FY 2015-2016 interim, but the commission has not made proposals for 2017 Legislative consideration at this time. Fully funding the functions of the school facility and technology account will be a pressure on general fund.

State and Local Infrastructure Programs 2019 Biennium General Fund Pressure			
Program	Funding Shortfall	Projected Funding Pressures	Total Pressure
Long-Range Building Program	$0	$40,031,767	$40,031,767
Long-Range IT Program	0	10,000,000	10,000,000
Local Infrastructure and Natural Resource Grants	1,000,000	13,279,350	14,279,350
School Facilities	4,800,000	16,800,000	21,600,000
Total	$5,800,000	$80,111,116	$85,911,116

Over the past several biennia, there has been increased interest in expanding the funding for infrastructure projects. While these LRP programs were solely supported by their dedicated revenues in the 2017 biennium, past legislatures have increased program funding through transfers of general fund into the programs. In the 2019 biennium, there could again be pressures to enhance infrastructure funding through transfers from the general fund and/or the authorization of bond issues. The table quantifies the general fund pressures that may be at play given both the shortfalls in funding current service levels and the interest in infrastructure program enhancements, amounting to $85.9 million. The level of enhancements is provided through a combination of average general fund transfers into these infrastructure programs (including the $0 transfer years and the 2013 biennium when funds were returned to the general fund) and normal program appropriation patterns (LRITP and School Facilities).

Non-General Fund Infrastructure: Road and Highway Infrastructure

The state's highway state special restricted revenue account (HSRA) provides the funding for construction and maintenance of the state highways and roads, and in the past four years expenditures have exceeded the tax revenues flowing into the fund by an annual average of $16.2 million, or 5.8% of total revenue. The net working capital balance of the account has been steadily declining, a condition that cannot continue without eventually impacting the service levels of the programs reliant upon HSRA, most notably highway construction and maintenance and the highway patrol.

In the 2015-2016 interim, the Revenue and Transportation Interim Committee has analyzed the HSRA from the prospective of both revenues and expenditures, but at this time the committee has not made proposals for the 2017 Legislature. Among the options available to the legislature is switching the financial support for some of the services from HSRA to the general fund, increasing pressures of the general fund.

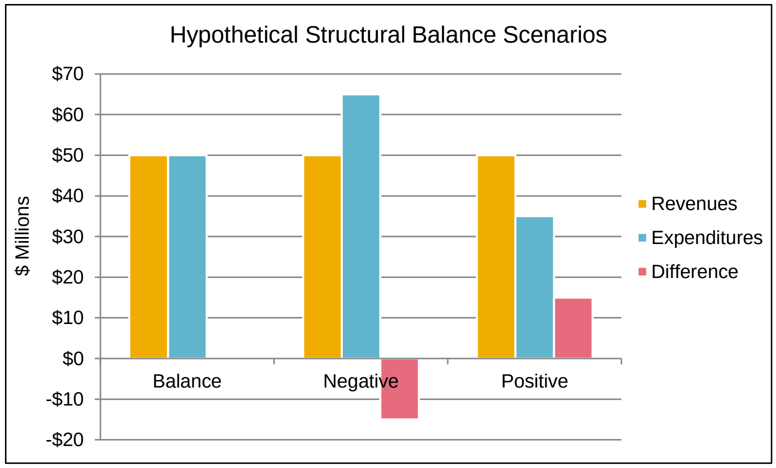
OTHER BUDGET CONSIDERATIONS

MANAGING BUDGET VOLATILITY

In all biennia volatile revenue streams are a possibility. As shown in the revenue section, annual general fund revenue growth has varied from -10.0% to +11.6% just since 2005. While some of these changes are predictable, many are not. Consequently, the ability to anticipate changes in revenue has been and will continue to be a challenge. Two tools are regularly used by the Montana legislature to mitigate revenue volatility risk: structural balance and ending fund balance.

Structural Balance

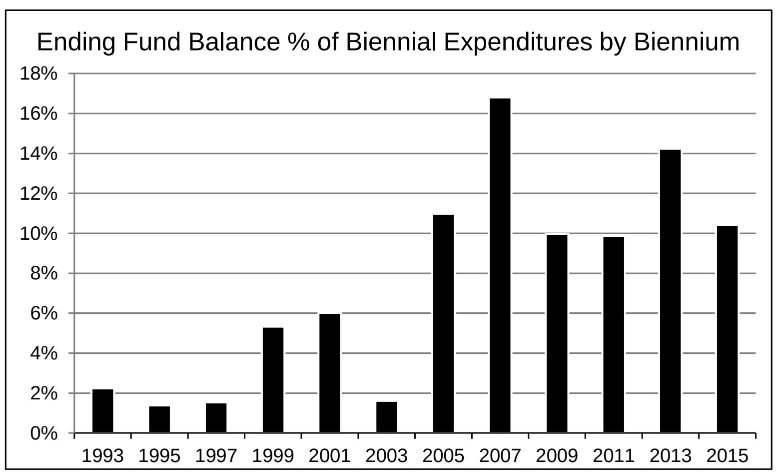
Structural balance is defined as the difference between ongoing revenues and ongoing expenditures during a fiscal year. Per the chart to the right, consider structural balance in three different scenarios.



1) Balance – Structural balance exists when ongoing revenues and ongoing expenditures are equal.
2) Negative – A negative structural balance exists when revenues (yellow bar) fall short of ongoing appropriations (blue bar). When this occurs, the ending fund balance could be utilized to supplement revenues to meet the expenditure demands. The shortfall can come from revenue volatility, costs of natural disasters, or other unanticipated costs.
3) Positive – A positive structural balance exists when ongoing revenues (yellow bar) exceed ongoing expenditures (blue bar). When this occurs, the ending fund balance is increased by the difference. The increase can come from revenue volatility or reduced expenditures.

Ending Fund Balance (EFB)

The general fund ending fund balance is effectively the "checking account balance" of the state. Most other states use a "Rainy Day Fund" to manage volatility. In recent years, Montana has used the general fund ending fund balance for managing volatility like other states use a "Rainy Day Fund."



The adjacent chart shows historical ending fund balances by biennium, which have varied from 1.4% to 16.8% of biennial expenditures.

Recent Changes with Volatility Impacts

<u>Wildfire Suppression Account</u>

[HB 354 (2013 Session)] added a permanent funding stream to the wildland fire suppression fund. The estimated FY 2016 fund balance of $70.0 million is approaching the fund's $100 million cap, and historical comparisons of wildland fire expenditures and the revenue streams now allocated to the fund suggest that the fund will be adequate for future expenditures.

Increased Ending Fund Balance Requirement

HB 588 (2015 Session) changed statute (17-7-140, MCA) to increase the triggers for mandating spending reductions from 2% to 5% of general fund appropriations for the second fiscal year of the biennium. For FY 2017, the trigger amount is $118 million.

Revenue Forecasting Changes

Updates to the forecasting methodology for individual and corporation income taxes may increase the risk of over-estimating revenues. Based on LFD research findings that the corporation income tax model underestimated revenues by an average of 8% to 9%, the model was adjusted to offset the statistical underestimate. As a result, corporation income tax is now equally likely to be overestimated as it is to be underestimated, which could shift the historical revenue risk to being more negative. However, a similar adjustment was made to the forecast for Treasury Cash Account (TCA) interest earnings, which has been consistently overestimated in recent years. The net effect of the two adjustments is small, thereby mitigating total revenue risk.

The individual income tax forecast has been revised to include an adjustment based on year-to-date revenue collections in the first year of the forecast. Such an adjustment may be positive or negative depending on how year-to-date revenues compare to the baseline forecast. By making the adjustment only to the first year of the forecast, there is not increased risk to subsequent years of the forecast. However, if current revenue collections are representative of an underlying change in taxpayers' incomes, the adjustment will not incorporate the future changes in revenue.

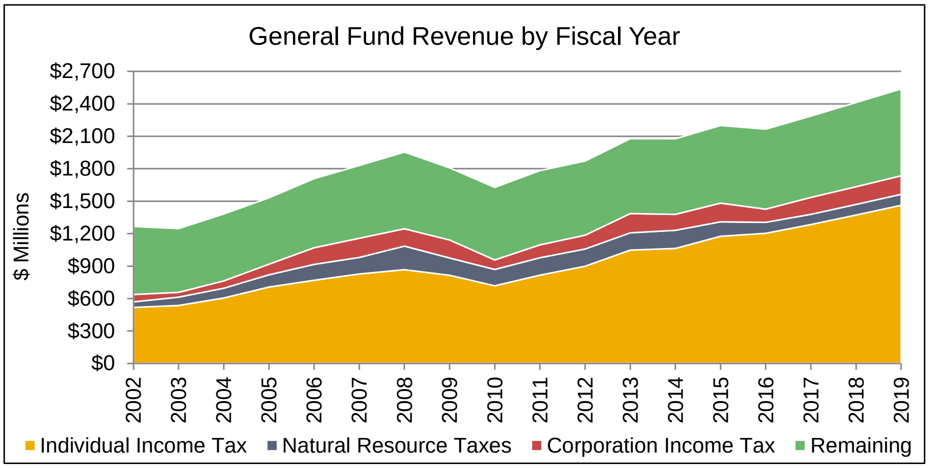
A Study on Improving Montana's Personal Income Tax Revenue Projections by LFD analysts evaluated the Rockefeller Institute of Government's analysis of all states' revenue forecasting, with specific emphasis on Montana. Based on the Rockefeller report analysis, continued legislative interest throughout the 2015 legislative session, and individual income tax increasing share of total general fund revenue, the LFD has focused on individual income tax forecasting as an area for potential improvement. Initial accomplishments include incorporating year-to-date revenue collections and building an alternative model based on quarterly revenue collections. Research on the implications of historical data and incorporating statistical findings of relative IHS accuracy is already underway; conclusions will be presented to the Revenue and Transportation Interim Committee meeting in September, prior to the revenue estimating presentation in November.

Other Research

The Legislative Finance Committee (LFC) considered the topic of managing volatility in the 2013 interim and further information on the subject can be found in the LFD's Managing Financial Volatility Report, which was published in September 2012. The plan is for the report to be updated and presented to the LFC in September 2016.

Revenue Risk

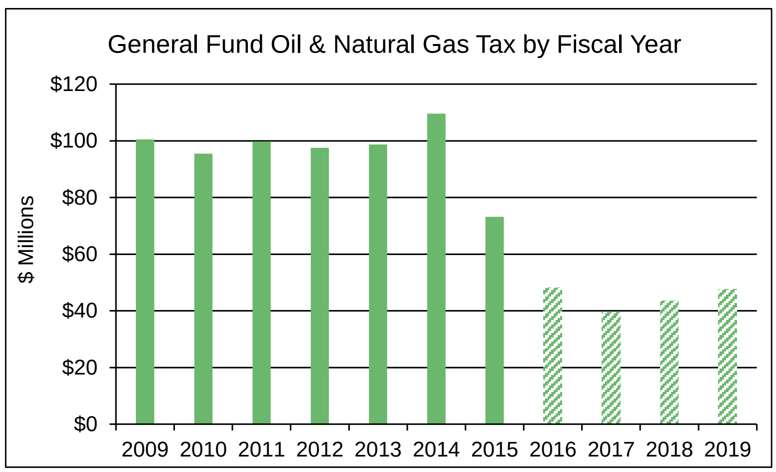
Increasing Individual Income Tax Reliance



Individual income tax has been a growing share of total general fund revenue since FY 2002, as illustrated in the adjacent chart. In FY 2002, it account for 40.9% of general fund revenue; based on the outlook forecast, it may account for 57.6% by FY 2019.

In fact, while all other sources combined grew an average of 2.4% annually from FY 2002 to FY 2015—nearly the same as the average annual inflation growth of 2.2% over the same period—individual income tax grew at an average annual rate of 6.5%. Although individual income tax is less volatile than corporation income tax or natural resource taxes, the increasing reliance on a single source of revenue may result in more exposure to forecasting error, as well as business cycle fluctuations.

Energy Revenues



General Fund

The recent drop in commodity prices, primarily oil and natural gas, has directly impacted state revenues in FY 2016 and will continue to impact revenues unless prices increase. From FY 2009 through FY 2014 oil and natural gas general fund collections ranged from $95.5 million to $109.6 million. FY 2015 general fund oil and natural gas collections decreased to $73.2 million and are forecast to be less than $50.0 million in each year of the 2019 biennium.

To see an increase in revenues in the next biennium, prices would need to rebound. New production would do little to increase revenues, as there is an eighteen month tax holiday for newly drilled wells. The decrease in oil prices is likely to have a secondary effect on both individual income and corporation income tax collections, as high-wage jobs in eastern Montana disappear and the energy sector sees declining profits from low prices. Furthermore, the revenues received from U.S. mineral royalties are also expected to decline. Under the federal Mineral Lands Leasing Act, 50% of all sales, bonuses, royalties, and rentals received from federal lands in Montana must be paid to the state. As drilling activity on federal land in the state declines a decrease in these revenues is likely to follow.

In addition to a decrease in natural gas tax revenues, the decline in prices in natural gas has allowed it to compete with coal as a major provider of domestic electricity. While coal prices are expected to remain constant, production is expected to begin decreasing, and already has in some areas. The revenue impact on the general fund from decreased coal production is not nearly as large as oil and natural gas, as coal severance tax collections in FY 2015 made up less than 1% of the entire general fund, all of which is statutorily appropriated to the Public Employees' Retirement System (PERS). However, funding for smaller state special revenue funds and local government funding will likely be affected by decreased coal revenues.

<u>State Special Funds</u>

Due to the decreased revenue from oil and gas sources and low interest earnings on the Resource Indemnity Trust, cash flow to the Resource Indemnity Trust related accounts will be impacted. The scope of this includes Natural Resource Operations, Natural Resource Projects, Environmental Contingency, Orphan Share, and others. These accounts have traditionally funded portions of the Department of Environmental Quality (DEQ) and the Department of Natural Resources and Conservation (DNRC) budgets. Preliminary revenue and expenditure estimates from the LFD suggest that some of these accounts may see significant shortfalls in the 2019 biennium. See page 27 for more information regarding this spending pressure.

While coal severance taxes make up a small percentage of the general fund, numerous state special revenue accounts could be impacted by declining revenue collections. These include the Long-Range Building Program, which receives 12% of total coal severance tax collections, the Coal Shared Account (5.46% of total collections), and the Coal Natural Resource Account (5.80% of total collections) among others. See page 27 for more information regarding this spending pressure.

<u>Local Government Funds</u>

Under current law, approximately 40% of oil and gas severance tax revenues are distributed to counties affected by oil and gas development. If oil and gas revenues remain below historical levels, many counties may need to find additional sources of revenue to maintain current service levels.

In the coming years, counties that have traditionally used coal mining and coal electrical generation as a portion of their tax base may see declines in this source of revenue. Many coal mines in the state supply a significant portion of their counties' total taxes. In addition to supplying revenue in the form of coal severance taxes, these mines also pay an additional property tax to both the counties and state. The decline in revenues could be further accelerated by policy decisions related to the Colstrip generating station. Recent legislation in Washington State authorized an avenue to pay for the eventual shutdown of Colstrip units 1 and 2. The speed at which decommissioning will take place is unknown, as is its effect on the entire plant. Just as coal mines serve as a primary tax base for their surrounding counties, Colstrip does the same for its corresponding county through property taxes. If Colstrip units 1 and 2 were to close, it is likely that Montana's coal production would further decrease as the Colstrip plant is a primary consumer of Montana coal.

EXPENDITURE RISK

Forecast Risk

Throughout the outlook, forecasts of populations served, enrollments, benefits, and inmates have been assumed based on historical and current trend information. Material risk to this forecast exists. The following table shows impacts if a 1% error in forecast occurs in one year or as a cumulative impact for multiple years.

General Fund Expenditure Forecast Risk ($ Millions)		
	1% error in one year	Cumulative impact of 1% error in FY 2018, and another 1% in FY 2019
Medicaid HB 2 caseload	$4.0	$12.0
Medicaid HB 2 FMAP state share	8.2	25.0
Medicaid Statutory Appropriation	0.4	1.4
Corrections populations	0.5	1.5
Office of Public Defender	0.4	1.3
K-12 enrollment	8.0	23.9
K-12 guarantee fund revenue	$0.5	$1.5

Medicaid HB 2 Caseload

A 1% annual change in traditional Medicaid from the budgeted FY 2017 level (exclusive of the HELP Act population) results in approximately a $12 million total budget increase. Approximately 30.1% of this is the responsibility of state funds, including both general fund and other state special funds, resulting in a state liability of $4.0 million for each 1% increase. Because state special revenues are required to be utilized first, it is reasonable to expect that additional growth would require primarily general fund.

Medicaid HB 2 FMAP State Share

The FMAP is set each year by CMS, and at the time of budgeting, LFD uses a projection of that FMAP, currently forecasted to be approximately 67.0% in FY 2018 and FY 2019. A 1% change in the FMAP will have an impact over $8.2 million each year. If the FMAP is off by 1% in FY 2018 and an additional 1% in FY 2019, the cumulative impact could be over $25.0 million.

Medicaid Statutory Appropriation

The HELP Act, passed in 2015, authorized an expansion of Medicaid under the Affordable Care Act, providing coverage to childless adults under 138% of the federal poverty level. The original assumptions in the fiscal note assumed a total potential population of 45,723 individuals, and that newly eligible enrollment would reach 42,573 by FY 2019. As of May 15, 2015, enrollment has reached 46,979. If the newly eligible population is closer to 70,000, enrollment would be expected to top 65,000 in FY 2019, requiring significantly greater levels of state and federal resources. An increase of 1% enrollment in each of the three years FY 2017 – FY 2019, has a cumulative 2019 biennium general fund cost of approximately $1.4 million.

Department of Corrections

The Department of Corrections has two areas of that present the greatest risk exposure:

- The population of individuals sentenced to supervision by the department
- Outside medical costs

Each 1% fluctuation in population, using the FY 2017 budget across the types of adult supervision (i.e. contracted portions of secure care and probation and parole) equates to a $1.5 million in general fund over the biennium

Office of State Public Defender

The Office of State Public Defender must provide defense of all individuals eligible, under constitutional or statutory provisions, to receive a defense. The number of cases the office will address during the 2019 biennium cannot be predicted accurately. As such, risk exposure is presented in the variability of caseloads. Each 1% increase in the number of cases above the five-year average new case assumption carries a $1.3 million biennium risk.

K-12 Enrollment

About 80% of state funding for schools is driven directly by student enrollments. An error of 1% in the forecast for enrollments would correspond to an error in the funding forecasts of about $5.3 million in the first year and $18.6 million in the second year of the biennium ($23.9 million total). In the past five years, the error in forecasting enrollments has been less than 0.2%.

K-12 Guarantee Fund Revenue

Revenue and interest from the guarantee account are statutorily appropriated to BASE Aid offsetting the need for BASE Aid. A 1% forecasting error in this revenue source would be a total $1.5 million for the biennium.

Additional Risk

CHIP funding was authorized by Congress in 2015, providing a higher level of state support than in previous biennia, which was realized in the 2017 biennium. However, this funding was only authorized through federal fiscal year 2017. Federal funding would need to be once again authorized to continue this level of support.

FIRE FUND

The outlook does not include general fund for the suppression of fires, but the control of fires is borne indirectly by the general fund. The fire suppression fund prior to FY 2016 received income from three general fund sources: general fund reversions above 0.5%, unused portion of the Governor's emergency appropriation, and a portion of corporation tax. The corporation tax portion sunset in FY 2015. The fire suppression fund has covered the state share of fire costs since FY 2013.

As of June 1, 2016, the fund balance in the fire suppression fund is $78.2 million. The Department of Natural Resources and Conservation estimates that at the end of the fiscal year, the balance will be $70.0 million. Since FY 2014, the state fire costs have been under $15 million per year. However, the fire fund could not support two years similar to FY 2013 when state costs ran at $57.5 million. Additionally, statute allows for up to $5 million each biennium to be used on fuel reduction and mitigation. Only if the state experienced multiple expensive fire seasons would there be a pressure on the general fund to support excess fire suppression costs.

OTHER FINANCIAL FACTORS

Pensions

At the end of FY 2015 both the Teachers' Retirement System (TRS) and Public Employees' Retirement System (PERS) amortized less than 30 years. In addition, both systems' amortization periods and funded ratios improved from FY 2014 levels. The funded ratios and amortization periods of the state's retirement systems as of July 1, 2015 are shown below.

Retirement System	Percent Funded	Years to Amortize
Public Employees' Defined Benefit Plan	76.1%	27.2
Teachers' Retirement System	67.5%	26
Game Wardens and Peace Officers	84.4%	Does not amortize
Highway Patrol Officers	65.1%	28.5
Judges	163.6%	0
Sheriffs	82.6%	Does not amortize
Municipal Police Officers	66.0%	18.3
Firefighters' Unified	75.5%	9.7
Volunteer Firefighters	75.4%	9.3

The major sources of funding for the retirement systems are employee and employer contributions, general fund statutory appropriations, and investment earnings. HB 454 from the 2013 Legislative Session created a statutory appropriation that used interest from the coal permanent fund and coal severance taxes as a funding source for PERS. The employee and employer contributions are set in statute, and therefore easy to predict. Investment earnings and coal revenues are much more volatile.

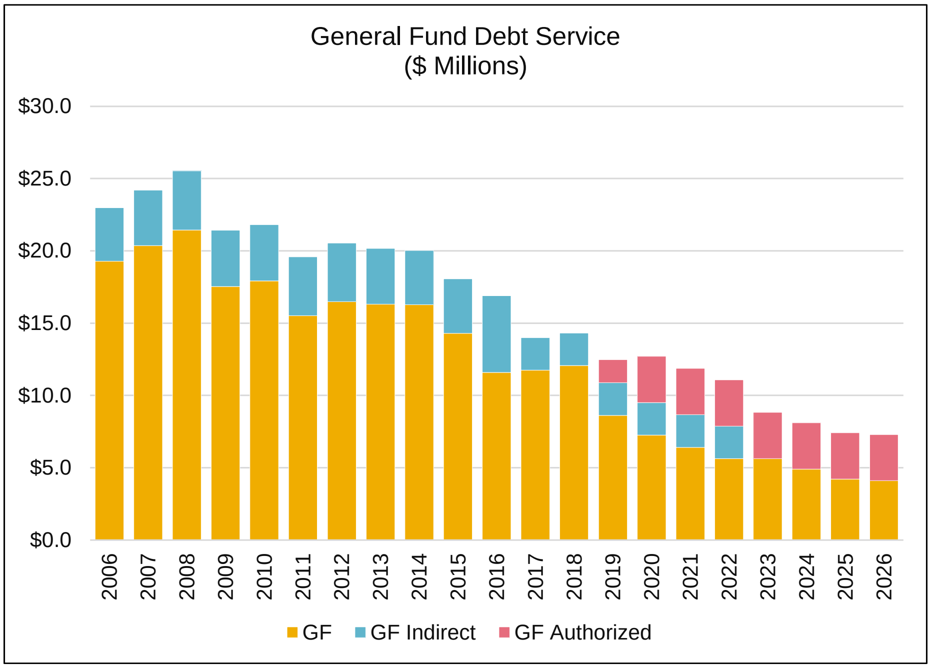
Recent regional and national pressures leading to the reduction in coal usage have raised concerns regarding decreased coal-related revenues to the state. This includes those coal revenues that are dedicated to PERS. In FY 2015 these revenues contributed $31.5 million to PERS. The Legislative Fiscal Division uses production surveys from coal companies within the state to forecast future coal revenues. If the coal production in the state were to drop by 10% compared to the surveys' estimates, this would result in a combined decrease of $2.1 million in FY 2018 and FY 2019 to PERS. A decrease of this magnitude would be unlikely to affect the health of the system, as combined contributions to the system from all sources in FY 2015 were estimated at $616.7 million.

Investment earnings, which constitute the majority of funds flowing into PERS, have averaged a 7.3% rate of return over the last ten years. The effect of market volatility on a system's health is significant, and therefore of legislative interest. Ultimately, this component of funding is the most volatile, in addition to being the largest. As a result, large deviations from the assumed rate of return of 7.75% can quickly increase or decrease the funded level of a system. Both the PERS and TRS will be providing the results of their FY 2016 actuarial studies, including revised amortization periods and funding levels, in the December 2016 presentation to the Legislative Finance Committee.

General Fund Debt Service

Significant investments in state infrastructure have been historically financed with debt in the form of bond issue proceeds. The level of Montana's tax supported debt is low when compared to other states[4], and the general fund obligation to debt service is projected to be less than $10.0 million per year by the end of the 2019 biennium, barring new issues. The following figure illustrates the debt service cost for issued and authorized general obligation (GO) debt, that debt where the full faith and credit of the state is pledged to the debt.

[4] "2014 State Debt Medians: Appetite for Borrowing Remains Weak". Moody's Investor Services. Montana tax supported debt per capita: $276 compared to the U.S. mean average of $1,436. Montana tax supported debt as a percent of personal income: 0.7% compared to the U.S. mean average of 3.2%.



The figure includes general fund historic debt service payments (2006-2016) and the debt service projections (2017-2026) for the following:

- General Fund – General obligation (GO) bonds paid by the general fund. The proceeds from these bond issues primarily funded the construction of state government buildings
- General Fund Indirect – This category includes GO bonds and special revenue bonds that are paid indirectly through the general fund. The related bond issues include state building energy conservation bonds and revenue bonds for two of the state's hospitals that offset general fund revenue through institutional reimbursements that would otherwise flow into the general fund
- General Fund Authorized – This category includes the projections for debt services costs on authorized but unissued bonds. Included in this category are two issues that cover the state's share of the costs of two tribal compacts, the state's share of the St. Mary's diversion structure repairs, and the remaining authority available for the Montana Heritage Center. For the purpose of this analysis, it is assumed that 20 year bonds would be issued for each of the items in the spring of FY 2019. Given the need for federal action for both the compacts and the St. Mary's project and the need for additional funding for the Heritage Center, this schedule may be optimistic and bond sales are likely to happen in later years

Without the issuance of new debt, the general fund debt service payments are projected to be approximately $10 million per year in the 2019 biennium and the indirect general fund payments are projected to be $3.3 million per year.

As mentioned above, there are four bond issues (uses) authorized by past legislatures that have not been issued. If these bonds were issued, the general fund cost in the 2019 biennium is projected to be $1.6 million and in the future $3.2 million per year.

At this time, there are two potential bonding issues that may be considered by the 2017 Legislature and the people of the state and could have general fund costs:

1) Confederated Salish and Kootenai Tribal Compact (CSKT) - The 2015 Legislature adopted the CSKT compact, which included $55.0 million for the state's share of mitigation projects. The state currently has two tribal compacts, the Ft. Belknap and the Blackfeet compacts, where significant portions of the total state funding share has been provided with the authorization of bond issues. The bonds will not be issued until the compacts are approved by the federal government. The 2017 Legislature may consider providing similar authorization for the project

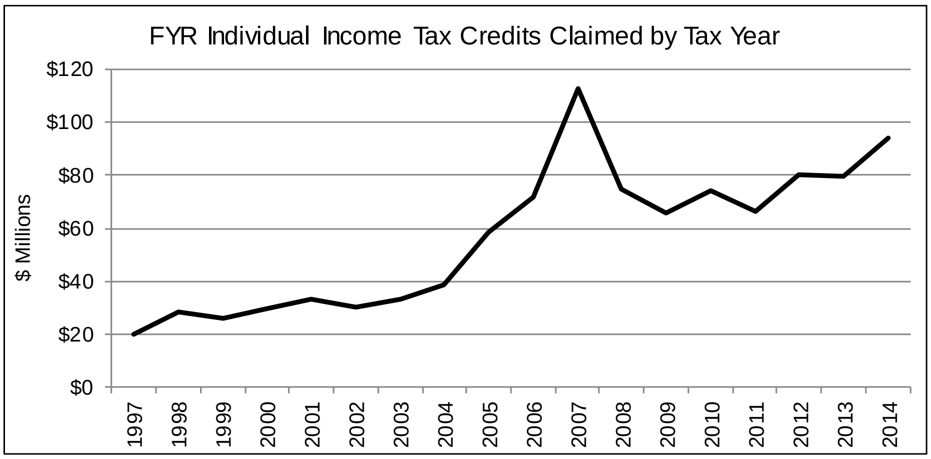
costs of the CSKT compact. Such an action is not likely to have a general fund cost in the 2019 biennium.

2) I-181 Promote Research into Developing Therapies and Cures for Brain Diseases and Injuries
I-181 is a ballot measure, currently approved for signature gathering, which would establish an authority for the purpose of promoting and providing grant funding to the development of therapies and cures for brain diseases and injuries and mental illnesses. The new authority/program would be administratively attached to the Department of Commerce. Grant funding would be provided through the state general obligation bond proceeds.

   I-181 authorizes the issuance of bonds of $20 million per year for a period of ten years. The fiscal note provides that with approval of the initiative, there will be a general fund cost of $5.6 million in the 2019 biennium. This figure includes $4.6 million of debt service costs and $1.0 million in bond issuance costs. In FY 2028, after all the bonds are issued, the general fund cost is projected to be $16.0 million per year.

Individual Income Tax Credits

Individual income tax credits are a growing source of tax expenditures, as shown in the adjacent chart. In 2014, the credits claimed by full year resident (FYR) individual income taxpayers amounted to $94.4 million, higher than any year besides 2007, in which the $140 homeowner income tax credit accounted for $24.6 million. In 2014, 96,843 FYR taxpayers claimed at least $1 of individual income tax credit out of a total 450,477 full year resident taxpayers—over 21% of taxpayers.



The LFD's Individual Income Tax Credit Analysis provides detailed information on "who" is taking the credits, as measured by average income level, and how "meaningful" the credits are relative to the average income of the taxpayers claiming the credits. The analysis also enamines the proportion of credit claimers that are repeat claimers of a particular credit, and the impact of credits on effective tax rates at various income levels.

The information provided in the Tax Credit report is complementary to that found in the Department of Revenue's Biennial Report. Legislative history and prior years' data, as well as policy highlights for each credit are found in the Tax Expenditures section of the 2012-2014 Biennial Report.

CHANGING EXPENDITURE PATTERNS

Department of Public Health & Human Services (DPHHS)

Within DPHHS there are a variety of programmatic and budgeting changes that make comparisons between the 2017 biennium and the 2019 biennium unsettled.

2015 Legislative Action

During the 2015 legislative session, a variety of initiatives were passed that significantly change the DPHHS budget. Two significant initiatives include:

- HELP Act Medicaid expansion
- Montana Developmental Center closure

<u>HELP Act Medicaid Expansion</u>

The HELP Act results in the expansion of Medicaid to cover childless adults below 138% of the poverty level. Through May, this has resulted in almost 47,000 new individuals on Medicaid, adding to the approximately 150,000 previously on Medicaid. The exact eligible population is unknown, but currently estimated to be approximately 70,000 individuals. The 2019 biennium general fund cost of this expansion is estimated at $69.7 million, but outstanding policy choices may result in significant changes to this estimate. Please note that the budget for the SB 405 HELP Act Medicaid expansion is included in statutory appropriations.

<u>Montana Developmental Center (MDC)</u>

The closure of MDC is a process that provides for a committee to make recommendations to DPHHS regarding the details of this process. Estimates included for the 2019 biennium are based on the committee recommendations, but the final Executive proposal has not been released, which may or may not precisely follow those recommendations. The recommendation utilized the full current budget of MDC, and expands the potential population by 50 individuals under a proposed waiver that would cost $4.0 million in FY 2017. The LFD has assumed the committee recommended expenditures are largely captured in the base budget and funds that might have reverted as a result of the closure will not materialize. Alternative assumptions on page 10 consider the possibility of not undertaking the expanded services recommended by the committee.

Interim Executive Initiatives

<u>Mental Health</u>

The legislature provided additional money for mental health initiatives including funding in FY 17 for a forensic wing at Montana State Hospital located in Warm Springs and dementia wing at the Montana Mental Health Nursing Care Center located in Lewistown. The Executive has expanded the scope of the forensic wing by increasing the support staff from 43.5 FTE to 59.6 FTE and by signing a long term facility lease located in Galen, MT.

<u>Child & Family Services</u>

DPHHS has added 42.5 modified FTE to address growing caseload and concerns in the Montana Child Protection System. The caseload in FY 2016 is almost double that of FY 2009, with the greatest growth since FY 2012. It is assumed that 30 FTE currently funded by vacancy savings will be requested in the 2019 biennium budget, but the final recommendations of the Protect Montana Kids Commission assigned to consider this issue are still unknown at this time.

Traditional Medicaid

Medicaid traditionally grows around 6.6% annually, based on Centers for Medicare and Medicaid Services projections for national Medicaid growth, not including the Medicaid expansion population. However, due to interactions with the HELP Act, over 8,000 individuals were removed from the traditional Medicaid system, benefitting Montana's general fund by transitioning them from 65% federally funded to 100% federally funded in calendar year 2016. This reduces the population by over 5.0%, significantly altering the traditional growth patterns. It is also expected that additional growth will occur due to the "welcome mat" effect, as people look into the expansion, only to realize they were already eligible for traditional Medicaid, and will be added to those rolls instead. This effect is almost impossible to accurately quantify.

The 2019 biennium estimate for Medicaid assumes 100% utilization of the Medicaid budget, either within Medicaid, or in non-Medicaid DPHHS programs. As described in the alternative assumptions on page 10, the Executive management of the budget to limit non-Medicaid benefit use of the Medicaid benefit appropriation could significantly alter these assumptions.

Potential Policy Impacts

Two significant opportunities have recently arisen that may reduce DPHHS general fund expenditures in the future. These are new enough that the financial impact is uncertain, and policies changes are not imminently expected. However, the opportunity to save general fund exists due to:

- New interpretation of Indian Health Service rules that could expand this 100% federally funded program
- Clarification of federal rules that should allow Medicaid coverage of individuals in Montana pre-release centers

<u>Summary</u>

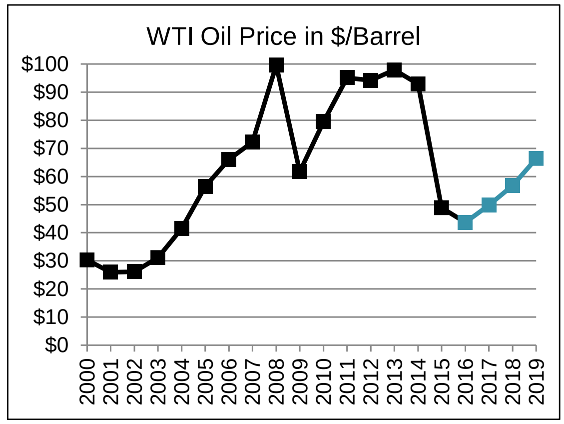
All of these changes to the DPHHS budget make the assumptions contained in the outlook preliminary and subject to a significant amount of change. The Legislative Fiscal Division will be tracking these budget issues and will present a complete analysis for the Legislature to consider in the 2017 Legislative Session.

APPENDIX A

Economic Highlights

Economic data provided by IHS, the econometric data service contracted by the state, forms the basis of most revenue forecasts. Many other data sources are used for historical information, but IHS is the primary source for forecast data. Details of selected variables are provided in this section.

West Texas Intermediate Oil Price

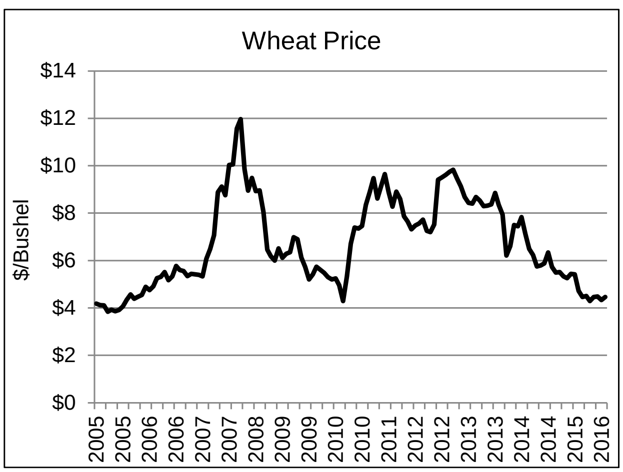


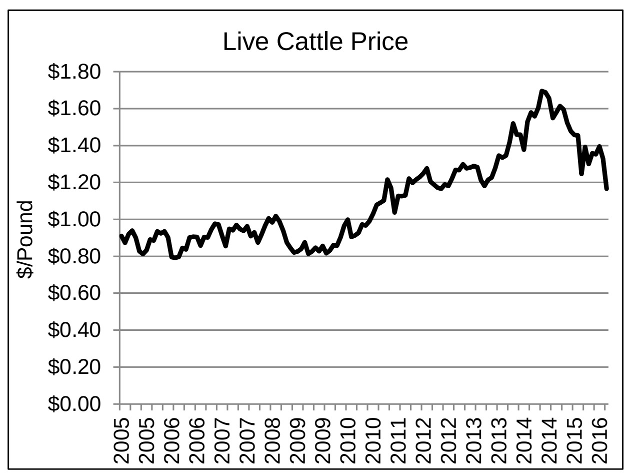
West Texas Intermediate (WTI) spot oil prices are a good indicator of Montana oil prices, and are used for the oil and natural gas production tax estimate. In addition, WTI price is used for several sectors of the corporation income tax estimate and the part of the individual income tax estimate.

After averaging about $100/barrel from 2011 through 2014, oil prices began declining in the fall of 2014. Prices are expected to average $40/barrel in 2016 and rise to near $70/barrel by 2019.

Agricultural Prices

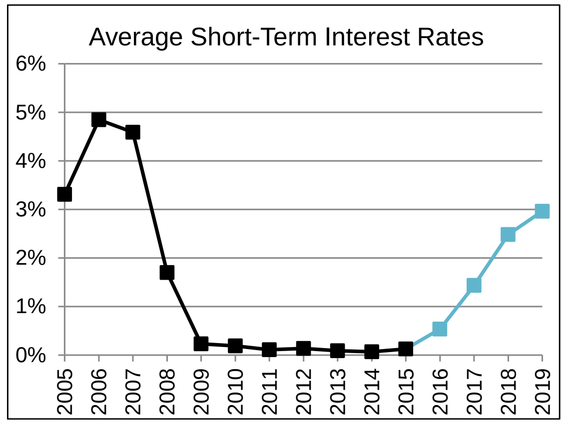
Historical wheat prices are based on hard red winter wheat from the USDA Market News as compiled by index mundi. Historical live cattle prices are compiled from investing.com.





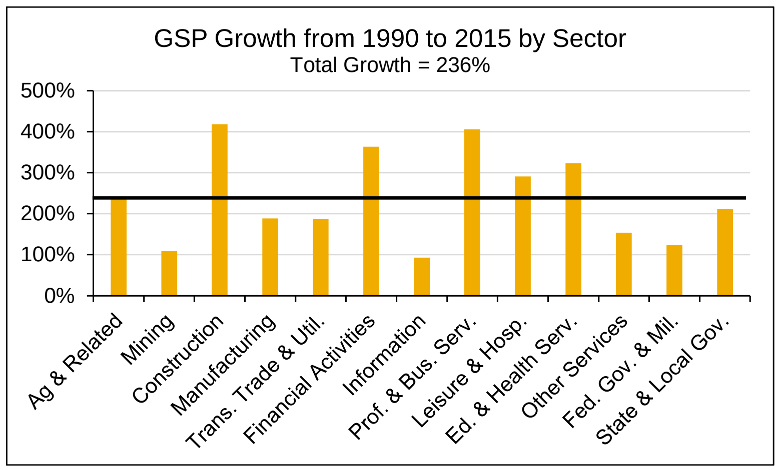
Interest Rates

A significant amount of total revenue comes from investment earnings on trust accounts and daily invested cash. Interest rates also affect the amount of investment income that is reported on individual income tax returns. Short-term interest rates have been at or near zero since 2009. Current IHS forecasts suggest this rate will increase to nearly 3% by the end of the outlook period. For the past three biennia, the IHS forecast has predicted an increase in short-term interest rates, which has not materialized. Based on historical IHS overestimates, the outlook for Treasury Cash Account interest earnings does not realize the full extent of the IHS predicted increase in short-term interest rates.



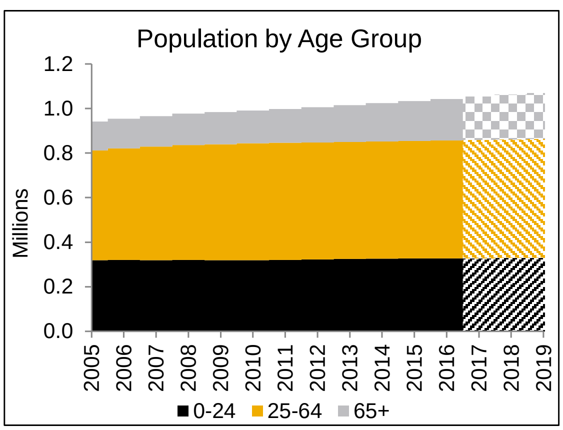
Gross State Product (GSP)

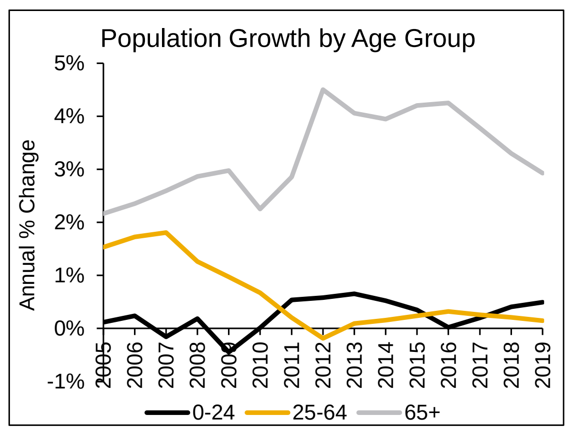
All broad industry categories have grown since 1990, as measured by GSP; however, the strongest growth has occurred in the construction, financial activities (which includes real estate) and professional and business services industries. These three industries combined accounted for 22% of total GSP in 1990, and grew to account for 31% of GSP in 2015. Total GSP in 2015 was $45.9 billion, compared to the GSP in 1990 of $13.7 billion. The total growth of 236% is represented by the thick black line in the adjacent chart.



Population

Population is used for estimating many revenue sources, particularly excise taxes such as beer and cigarette tax. Population also impacts income and employment, and statewide economic activity.

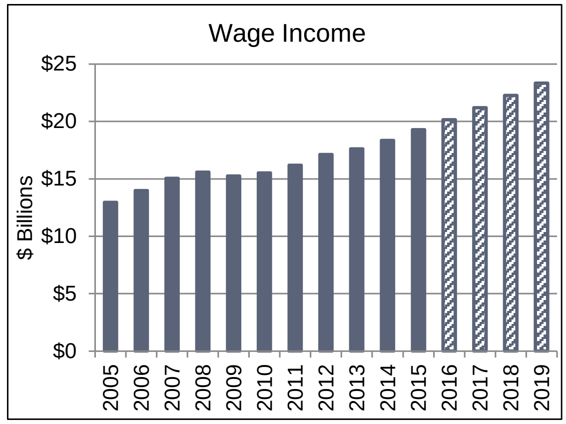




Wages

Wage income accounts for nearly two-thirds of individual income, and individual income tax accounts for about half of general fund revenue. Although wage income is not as volatile as several other income or revenue sources, even small changes in the outlook for wage income and produce large swings in the revenue estimate.

The IHS wage disbursements variable for Montana is probably the single most important underlying indicator in the entire general fund revenue estimate. The average growth for the outlook period is 4.9% per year.



Median House Price

Median house price is used in the capital gains income portion of overall individual income tax, as well as corporation income tax estimate. After four consecutive years of decline during the last recession, median house price passed the 2007 peak in 2014; IHS assumes an average of 4.6% annual growth for the forecast period.