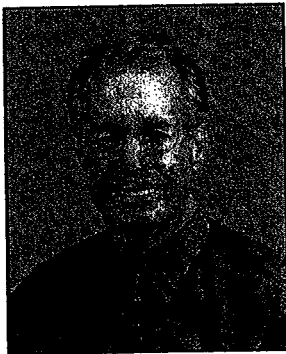


## When Revenue Forecasts Collide: Montana's Squabble

by Billy Hamilton



Here's the thing about state revenue forecasts: No matter what structure states use to produce them — no matter how sophisticated the analysis that goes into them — they can't be divorced from politics. The latest evidence of that fact can be found in Montana. On September 26 David Ewer, the budget director for Gov. Brian Schweitzer (D), told an interim legislative committee that the State Legislature, controlled by Republicans, had been too willing to accept unreasonably low revenue estimates in developing the state budget earlier this year.

Democrats believe the lower estimates resulted in the Legislature refusing to fund a negotiated pay raise for state employees and making cuts in human services spending, among other things. The implicit message was that lawmakers had used the revenue estimates as an excuse for spending cuts that otherwise weren't necessary.

Republicans on the Revenue and Transportation Interim Committee, where Ewer testified, countered that lawmakers were wise to use the lower estimates because of the possibility of a second recession. "I think we were correct to take a conservative view, keep the grain in the bin, as the governor says," said Sen. Bruce Tutvedt (R).

It's hard to judge whether there was any motivation behind the Legislature's decision beyond caution, but Ewer has a point about the forecasts. At the same meeting, Terry Johnson, the Legislature's chief revenue forecaster, reported that the legislative staff's initial prediction of a \$150 million revenue surplus at the end of 2013 — the end of the budget period that just started — was being increased to \$265 million.

Ewer told the committee that even that increase was too low by at least \$50 million. Individual

income taxes were up by nearly \$54 million in fiscal 2011, and corporate income taxes increased by about \$22 million.

If all this sounds technical or trivial, it isn't. Granted, revenue estimates occupy an arcane corner of an arcane subject — taxation — but they can have serious real-world consequences if they're off target.

Just how serious can be arresting to contemplate. Research by the Pew Center on the States and the Nelson A. Rockefeller Institute of Government found that in fiscal 2009, "the errors by states in forecasting personal income, sales, and corporate income tax collections added up to a \$49 billion unexpected revenue shortfall."<sup>1</sup> That's a staggering amount coming in a year in which state lawmakers faced \$63 billion in midyear budget gaps — coming atop \$47 billion they had already closed when they adopted their budgets. "The missed forecasts contributed to the need for tough and unexpected choices to cut spending, increase taxes, draw from reserves and borrow money," the report concludes.

Of greater relevance in Montana's case, the study finds that state estimators are having increasing difficulty forecasting both positive and negative changes in the economic outlook and their effects on the tax system. "The revenue overestimates during the nation's past three recessions grew progressively larger as did the underestimates in the past two periods of economic growth," the report says.

This finding might justify the legislative staff's desire for caution, but what it really shows is how much trouble forecasters have catching turns in economic activity in whichever direction. In 2009 the economy slid, and forecasts were too high. That happened in Montana, where a projected surplus of \$1.2 billion melted away in the months leading up to

<sup>1</sup>The Pew Center on the States and the Nelson A. Rockefeller Institute of Government, "States' Revenue Estimating: Cracks in the Crystal Ball," March 2011, available at [http://www.pewcenteronthestates.org/uploadedFiles/States\\_RevenueEstimating\\_final.pdf](http://www.pewcenteronthestates.org/uploadedFiles/States_RevenueEstimating_final.pdf).

the 2009 legislative session.<sup>2</sup> Lately, forecasters have underestimated the effects of the recovery, such as it is, and actual collections have run ahead of estimates. Either way, missed estimates can put lawmakers in the uncomfortable position of making cuts or increasing taxes more than expected — or more than is necessary.

Revenue forecasts aren't a new source of friction between the governor and Legislature in Montana. The current issue has been simmering for over a year. It's partly a result of the normal gap between how governors and legislatures see their respective jobs, but it's also a function of how the state does its revenue estimating. The Legislature has its own forecasting group, the Legislative Fiscal Division, while the governor relies on Ewer's Budget and Program Planning staff. Some states like Texas have one source of revenue estimates; others, like Florida, use a consensus approach; and others, like Montana, often wind up with dueling views of the future from the legislative and executive branches.

The origins of the current squabble can be traced to January 2010. Until then, the state had struggled along fairly successfully through the recession and its aftermath. Although it experienced budget problems in 2009, it was one of the few states to escape the worst of the recession, helped along by its energy sector and its conservative spending habits. However, in January of last year, conditions appeared to be deteriorating. According to one expert, this revenue problem had nothing to do with the Montana economy, which was doing fine, but was really a residual effect of the stock market crash and the decline in corporate earnings that followed. Johnson told a legislative interim committee that Montana's general fund surplus would be only \$16.9 million by the end of fiscal 2011. The estimated surplus had been \$44.4 million in his December report.

While any budget surplus is good news in these troubled times, the \$16.9 million surplus represented only a fraction of the \$282 million target that legislators set for the general fund during the 2009 legislative session. It also equals only a little more than one-half of 1 percent of the state's total two-year general fund budget of \$3.7 billion.

Faced with this flagging outlook, Schweitzer ordered agencies to submit plans on how to reduce their budgets by 5 percent. He also said he had "exhausted all the easy ideas," and so he turned for help to his constituents. His website featured a pink piggy bank that people could click on to submit their ideas for trimming state spending.

<sup>2</sup>Jeffrey D. Greene and Mike Vandenberg, "The Montana 2011 Biennium Budget Update: April 2009," *The California Journal of Politics and Policy*, Volume 3, Issue 2, 2011.

At that point the governor's office generally agreed with the Legislature's reading of the revenue situation. According to Ewer, the budget office's analysis found Johnson's estimates to be "in the middle of our range." "We still have a projected \$16 million in the bank. Hallelujah!" he said. "We have this situation because Governor Schweitzer insisted on having large reserves."

The question, though, was whether the legislative forecasters were misreading the situation. In February 2010 Ewer appeared before the Revenue and Transportation Interim Committee and said the turnaround was occurring that very month, a nervy piece of forecasting — and amazingly, one that turned out to be right on the nose.

But that result had to wait for actual collection data. In the meantime, legislative estimators were predicting budget problems ahead, forecasting a potential budget deficit of more than \$400 million by the end of fiscal 2013, assuming the 2011 Legislature set a \$100 million budget surplus target.

At the legislative hearing where Johnson presented this news, the governor's deputy budget director was asked if the governor's staff agreed with the legislative assessment. She said it was early in the budget process but that "the two offices are not that far apart" in their revenue forecasts — they were, she said, in the neighborhood.

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Back once again to report to lawmakers in September 2010, Johnson continued to paint a bleak picture of the fiscal outlook, tempered this time by some good news. He said that the projected general fund budget balance for the two-year budget period ending in mid-2011 was expected to be as high as \$235.6 million instead of \$16.9 million. "That's considerably better than it was back in January," he told the Revenue and Transportation Interim Committee — about 14 times better in fact.

The bad news was that the 2011 Legislature, which would convene in January, still faced a \$400 million budget shortfall by the end of 2013. "We will end the year with a pretty good balance, but it really doesn't help us for the next two-year budget cycle," Johnson said. This effectively set the table for a legislative session focused on budget cutting. It also marked the point where the Legislature and Schweitzer split loudly and publicly over the estimates.

Despite the legislative staff's gloomy prognosis, the state's revenue situation had been improving,



and the governor thought the outlook was considerably brighter. He dismissed the legislative forecast as unreasonably dismal. Actually, his assessment was a little saltier than that. "Crazy," Schweitzer said of the Legislative Fiscal Division's estimates. "I looked at that stuff, got to the third page and threw it in the garbage."

"I'm not saying it isn't going to be tight," Schweitzer told a group of county commissioners. "If you got ideas for more spending, maybe in your county, now is not a good time." However, the governor said, things were looking up. After a 22-month slide in state tax collections related to a slumping economy, revenue collections had increased for four straight months. Market prices for wheat and cattle were up, which he said should improve consumer spending and eventually bolster the state's coffers as well.<sup>3</sup> The legislative estimates had been overly conservative in the past and were again, he said.

<sup>3</sup>Tom Lutey, "Schweitzer Optimistic About State Budget Despite Forecasts," *Billings Gazette*, Sept. 27, 2010, available at [http://billingsgazette.com/news/state-and-regional/montana/article\\_332b0e4a-caac-11df-ad56-001cc4c002e0.html](http://billingsgazette.com/news/state-and-regional/montana/article_332b0e4a-caac-11df-ad56-001cc4c002e0.html).

Suddenly, the revenue forecast had become a political football, and the timing wasn't coincidental. The November elections were approaching, and on the campaign trail, Republicans were telling voters that the state had created a government it couldn't afford and that deep budget cuts were the only solution. Schweitzer told the county commissioners the numbers didn't support that claim. He said the Republicans had fought him on building a reserve in the 2009 session, but that it had been the right call. "I'm not going to apologize to anybody for putting that money aside," he said. "The next time one of these jokers shows up you can say," well no, I know the real numbers."

On November 15 the governor presented his 2012-2013 budget. He proposed about \$3.7 billion general fund spending, including maintaining a reserve at the end of 2013 of \$129 million. His plan increased spending for schools and universities, cut other areas of the budget, and proposed two tax cuts.

One tax proposal would eliminate the 3 percent state property tax on business equipment for businesses with less than \$1 million in equipment. Schweitzer said this would eliminate the tax for 17,000 businesses, leaving only 450 of the largest businesses, such as big oil companies with Montana refineries, paying the tax. He also proposed enacting an income tax credit for homeowners meant to offset property taxes on their primary residence. The credit would be worth \$50 per homeowner in 2012 and \$100 the following year. "This budget is going to cut more taxes for more Montanans than any budget in the history of Montana," Schweitzer said at a news conference.

Effectively the governor was seizing the high ground on two traditional Republican issues, cutting spending and reducing taxes.

The governor's budget was based on a forecast prepared by his budget office, but the Legislature was to have the final say in the matter. Lawmakers didn't wait long to undercut him. On November 19 the Revenue and Transportation Interim Committee unanimously endorsed its staff's recommended revenue estimates, adopting an estimate considerably lower than the one from Schweitzer's office.

Much was at stake in this decision. Montana's constitution says that state general fund spending can't exceed estimated revenue, and the revenue estimate would loom as a central issue (along with medical marijuana, oddly enough) when the Legislature met in January.

The governor's office wasn't happy about having its budget work upended. Ewer appeared before the committee at the hearing arguing for higher estimates. He said state tax collections in August, September, and October were up by more than 11

percent overall, a sign that the economy was rebounding. "Come January, I think we have a significant likelihood of upside revenue estimates," he told the committee. If the trend held up, he said, the legislative estimates would be low by as much as \$100 million.

Perhaps, but the immediate effect of the legislative committee's decision was to lower to \$84 million Schweitzer's proposed general fund budget ending balance. Republican legislative leaders, though, made it clear they were looking to cut budgets further and not raise taxes. In other words, they were upping the ante to reclaim the conservative high ground.

**'What are you going to believe?' Schweitzer asked. 'All of these modeling numbers that have been wrong for the last 10 years or your own lying eyes? Their estimates not only have been wrong, but wildly wrong.'**

The governor didn't mince words about the committee's decision. He criticized the committee members for relying too much on revenue forecasting and economic modeling that he said had been inaccurate in the past. "What are you going to believe?" he asked. "All of these modeling numbers that have been wrong for the last 10 years or your own lying eyes? Their estimates not only have been wrong, but wildly wrong."

Legislators responded that they were just being cautious given the general economic uncertainty. "I think it's the most conservative approach," said incoming Senate President Jim Peterson (R), adopting a litany that would be heard often in the months ahead.

The revenue estimate dispute continued to boil during the legislative session but really began to come to a head on March 17 when the issue reached the House Taxation Committee.

The tax committee was considering House Joint Resolution 2. The resolution contained the projected revenue estimates adopted by the interim committee in November. The tax committee could accept or reject the interim committee's recommendations, as well as incorporate changes in the forecast since November. Democrats and a number of human services advocates urged the committee to boost the estimate to the level proposed by Schweitzer so lawmakers could restore budget cuts made in the early work on the budget.

Since November, the revenue estimators hadn't steered a particularly steady course. The legislative staff raised its estimate by \$97 million in mid-February. Then, just before the House hearing in

March, they reduced it by \$33.5 million, bringing the original estimate up by \$63.5 million, still \$104 million less than what the governor's budget office was saying the revenue estimates should be.

Even considering the economic uncertainty at the time, this peripatetic path probably didn't inspire confidence. Since the estimates cover three years, 2011 through 2013, the \$104 million amounted to just less than 2 percent of the budget over that period, but in a legislative session in which everyone wants more money, \$100 million carries a lot of weight.

Johnson said the adjustments were made because corporate income taxes were down because of a change in federal tax law on business equipment depreciation that would cost the state \$20.5 million over the next two years. He also said he made adjustments in video gambling revenue, which he said was declining, and some other revenue sources as well.

Rep. Roy Hollandsworth (R), who sponsored the resolution adopting the interim committee estimates, advocated caution. "Don't be jumping on the bandwagon to get these estimates higher," he said. "I call the economy fragile."

The governor's budget staff again waded in on the side of optimism. "I have to stand up in strong opposition," Ewer said. "It's woefully understating what's likely to be stronger revenue." He also said: "For his [Johnson's] numbers to be proven accurate, the Montana economy will have to go into an economic tailspin. . . . That's absurd."

Once again, lawmakers disagreed. The tax committee adopted the legislative estimates, and sent the resolution to the full House of Representatives. The House passed HJR 2 on March 28, but then sent it back to committee before final passage in an apparent move to prevent it from reaching the Senate. This marked the third straight session that the House had prevented the Senate from considering the resolution. Asked why he sent HJR 2 back to committee, House Majority Leader Tom McGillivray (R) was unusually candid: "Essentially, the House wants to keep control of that bill."

This bizarre maneuver is within state law. The statutes specify that the official revenue estimate of the legislative branch is the revenue and taxation recommendations or an amended version from a legislative committee. This means the revenue-estimating resolution is not required to be passed by both — or either — house, and it also means the House can determine the anticipated level of revenue without Senate consideration simply by refusing to finally pass the revenue estimating resolution.

In any case, the estimate was now set and it was what budget writers had to work with. On April 20, eight days before the end of the legislative session, lawmakers passed a budget based on the lower

estimates. It then recessed to see if Schweitzer would exercise his amendatory veto powers.

Under the state's amendatory veto provision, a feature Montana shares with five other states, the governor can revise bills after they've been approved by the Legislature with any revisions subject to legislative approval or revision. The law gave Schweitzer until April 23 to propose amendments.

Schweitzer warned that much in the bill warranted a veto and criticized the Republicans for recessing while work remained to be done. "They're going to run out of those rum drinks in Cancun with all those spring breaks," Schweitzer said, referring to the fact that the April 20 recess was the second recess that lawmakers had taken in two weeks.

The possibility of a budget meltdown so near the end of the session apparently got everyone's attention, and a couple of days later, the governor and legislative leadership hammered out an 11th-hour budget deal. "I'm here to say that we have a deal. That deal means I am sending an amendatory veto back to the Legislature and every word in that amendatory veto has been agreed to by the three of us," Schweitzer told the press. The "three of us" included him and the leaders of the two legislative houses.

The amendments added back nearly \$100 million in federal funds, which the Legislature had previously rejected because, apparently, it carried the taint of Washington. Schweitzer said the budget cut government spending by about 6 percent compared with the previous two years and would leave \$200 million in the bank.

The Legislature passed the bill on April 26 and adjourned two days short of the regular end of the regular session on the 90th day. That left the governor with one more bite at the apple since the bill would now come to his desk for possible line-item vetoes and final approval. Schweitzer initially said he would use his veto power to strike more spending, but on May 12, he signed the bill into law without any major changes.

The next day Schweitzer also signed SB 372, sponsored by Tutvedt, which lowered the business equipment tax by 1 percent on the first \$2 million worth of property. The governor's proposal to eliminate the business equipment tax entirely for 98 percent of all Montana businesses didn't make it out of committee, nor did the income tax break for homeowners.

The governor complained that Tutvedt's bill reduced taxes but gave away hundreds of thousands of dollars of tax breaks to large, out-of-state corporations. "Remember they don't eliminate the business equipment tax for anybody," he said. "They lower it by 1 percent. Now lowering it by 1 percent is not a bad thing. If we elect Republicans for another 99 years we'll get to 100 percent," he said, showing a

questionable grasp of the math involved. The bill will cost the state \$14 million a year.

This brings us back full circle to the recent revisions of the revenue forecast. Since the end of the legislative session in April, revenue has performed pretty much as the governor's office predicted, and hence the governor's desire to wag a finger at lawmakers and say, "I told you so."

**The Montana House can determine the anticipated level of revenue without Senate consideration simply by refusing to finally pass the revenue estimating resolution.**

Democrats said an accurate forecast would have allowed them to fund the pay increase the Schweitzer administration negotiated with state employees — a failure that led the unions to file an unfair labor practice charge. Democrats also wanted a bonding bill to launch a round of new building projects and provide more health and human services funding. None of that happened, and it didn't happen because the revenue estimate was too conservative.

This is the revenue estimator's lot in life. Whatever the legislative leadership's agenda, I doubt the staff intended to be overly conservative. In fact, it's difficult to blame the estimators entirely for erring on the side of caution given the overestimate leading up to the 2009 session. The economy is shaky, and an old revenue-estimating rule of thumb is that the penalty for overestimating is much worse than the penalty for underestimating.

Still, this raises another problem that revenue estimators must avoid. In the interests of safety, estimators can become so conservative that they constipate the budget process and prevent important programs from being funded. The weight of this problem multiplies when money is short and every dollar counts.

It becomes an even bigger problem when politics seeps into the process, as it inevitably does when you have two sides fighting over spending priorities. The fact that Montana's process relies on two different revenue forecasts adds further complications. Every state with a dual system seems to have problems because when there are two estimates from which to choose, it's always tempting to pick the estimate that matches your policy agenda, whether it makes sense or not.

All revenue estimates, including Montana's, share one final characteristic. There comes a day of reckoning — all fiscal years end eventually and actual numbers become available. Most estimators realize that when their forecasts are badly off the mark, no one is going to understand their technical

explanation of what went wrong — or sympathize with it. That's the problem the legislative estimators confronted at the September 26 hearing.

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After giving his update, Johnson took a stab at explaining the results of 2011. It wasn't their fault. The legislative staff had received conflicting economic forecasts from private national forecasting firms and a federal government source about Montana's economy, he said. "The conclusion at this point is we have some research to do," he said.

Sen. Ron Erickson (D) said he was surprised that Johnson was surprised by how much additional money the state collected in 2011. He said:

A lot of us aren't surprised. The budget director [Ewer] and a number of us thought the revenue estimates should have been higher. We were coming out of a recession.

Ewer's assessment was more to the point: "If you as a legislature continue to accept the status quo methods, I think you're having revenues that are undercounted. And that's bad business." He predicted that fiscal 2012 revenue would be "dramatically higher" than the legislative staff was predicting.

Ewer also said being conservative is less important than being accurate. "It is my continued hope that we all want accurate revenue estimates. I hope that is the goal," he said. "I hear there is some praise for having them be conservative. I think accuracy is more important."

Actually, estimators need to be both accurate and conservative. They need to have enough nerve to push the estimates as high as possible but retain enough caution in the forecasts to avoid overestimating. It's a delicate balance and more art than science. No mathematical model can tell you where the "sweet spot" is. The gut makes the call. That's why estimator's stomachs churn so much these days. ☆

