GENERAL FUND REVENUE UPDATE FISCAL 2010

A Report Prepared for the

Legislative Finance Committee

By

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INTRODUCTION

The purpose of this report is to provide the committee with general fund revenue collection data through May FY 2009 compared to May FY 2010. This and future updates are intended to provide the most recent information on general fund revenue collections as we proceed through the 2011 biennium. These reports, most of the time, will only highlight the significant revenue sources with a brief explanation of what trends may be developing. It should be noted that these reports are designed to be similar in content and structure from month to month so new readers will have the benefit of the historical information provided.

As a reminder, during the 2009 legislative session, our office recommended to the 61st Legislature that the general fund revenue estimates be decreased by $292.6 million for fiscal 2009, 2010, and 2011. The House Taxation Committee adopted these recommendations and included the assumptions in HJ 2, the revenue estimating resolution. The reduced revenue was anticipated from major sources such as individual and corporation income taxes and oil and gas production taxes. The revenue estimates used by the legislature for the 2011 biennium have been incorporated into this report.

THE BOTTOM LINE

Total general fund revenue collections through May continue to lag the revenue estimates used by the 61st Legislature for FY 2010. As shown in Figure 1, total general fund revenues for the 2011 biennium are estimated to be $349.9 million less than anticipated by the 61st Legislature, the same amount as estimated since February. It should be noted, however, that individual income taxes are expected to decline more than portrayed in Figure 1 ($15 million more per year). Conversely, corporation income taxes are not expected to decline as much as shown in Figure 1 ($15 million less per year). Since the adjustments would be offsetting, the total anticipated shortfall remains unchanged. Therefore, total general fund collections are still expected to be below the HJ2 revenue estimates for the 2011 biennium by $349.9 million.

Figure 1

Estimated Revenue Changes From HJ 2 (Millions)

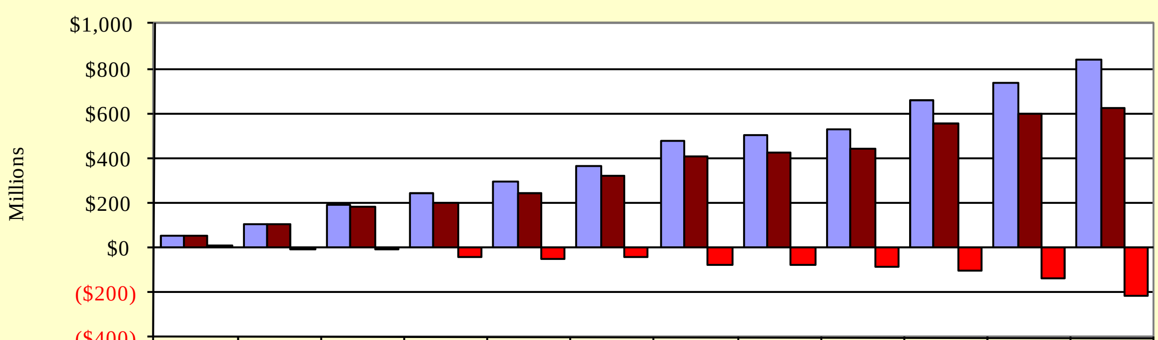
Category	FY 2010	FY 2011	Biennium
Individual Income Tax	($118.1)	($95.0)	($213.1)
Corporation Income Tax	(58.2)	(52.7)	(110.9)
Oil & Gas Production Tax	21.3	12.3	33.6
TCA Interest	(4.5)	(6.4)	(10.9)
Video Gaming Tax	(11.5)	(11.1)	(22.6)
Vehicle Fees/Taxes	(7.0)	(4.8)	(11.8)
Remaining Sources	(4.1)	(10.1)	(14.2)
Current Estimate	**($182.1)**	**($167.8)**	**($349.9)**
February Estimate	($182.1)	($167.8)	($349.9)
Change From February Estimate	**$0.0**	**$0.0**	**$0.0**

Figure 1a shows cumulative individual income tax collections through May versus the HJ 2 annual revenue estimate allocated by month. As shown in Figure 1a, individual income tax collections are not keeping pace with the HJ 2 estimate and are lagging the HJ 2 estimate more each month. Our statistical analysis, however, suggests the February estimate should be adjusted downward based on data through May. The potential downward adjustment could be in the range of $15 million for each year. This adjustment has not been included in Figure 1 at this time.

The difference shown for December in Figure 1a, however, did show a small improvement from previous months. This was because November's difference "spiked" due to an unusual large refund that reduced collections significantly

Figure 1a

Individual Income Tax - Expected vs. Actual Collections (Cumulative)

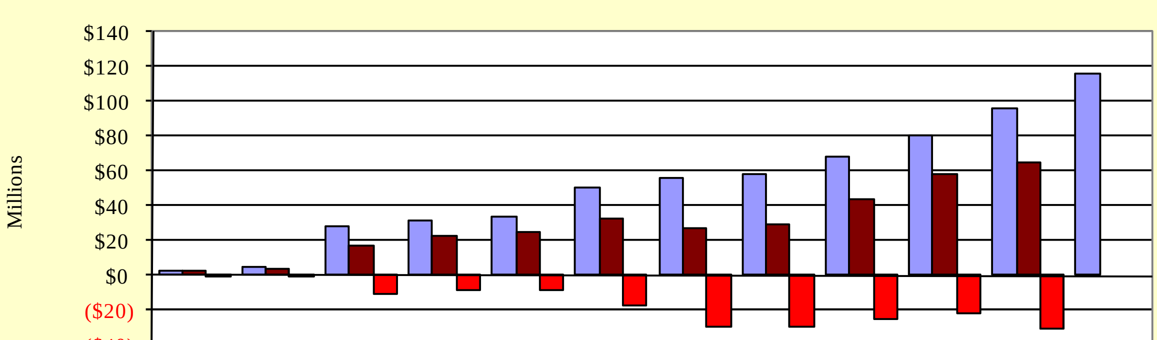


	01 Jul.	02 Aug.	03 Sep.	04 Oct.	05 Nov.	06 Dec.	07 Jan.	08 Feb.	09 Mar.	10 Apr.	11 May	12 Jun.
Expected	52.871	107.861	195.320	243.670	299.187	365.083	481.146	499.579	529.424	656.400	734.928	840.263
Actual	53.646	103.783	185.451	204.037	247.759	321.562	409.259	421.848	443.608	553.549	595.586	623.876
Difference	0.775	(4.078)	(9.869)	(39.633)	(51.428)	(43.521)	(71.887)	(77.731)	(85.816)	(102.851	(139.342	(216.387

Figure 2 shows cumulative corporation income tax collections through May versus the HJ 2 annual revenue estimate allocated by month. As shown in Figure 2, corporation income tax collections are not keeping pace with the HJ 2 estimate but the difference between estimated and actual collections declined during March and April and then increased again in May. Our statistical analysis, however, suggests the February estimate should be adjusted upward based on data through May. The potential upward adjustment could be in the range of $15 million per year. This adjustment has not been included in Figure 1 at this time.

Figure 2

Corporation Tax - Expected vs. Actual Collections (Cumulative)



	01 Jul.	02 Aug.	03 Sep.	04 Oct.	05 Nov.	06 Dec.	07 Jan.	08 Feb.	09 Mar.	10 Apr.	11 May	12 Jun.
Expected	3.255	5.182	28.002	31.858	33.739	50.821	56.564	58.678	68.337	80.552	96.427	115.638
Actual	2.349	4.158	17.635	23.299	25.513	33.045	27.243	29.177	43.595	58.371	65.533	-
Difference	(0.906)	(1.024)	(10.367)	(8.559)	(8.226)	(17.776)	(29.321)	(29.501)	(24.742)	(22.181)	(30.894)	-

When the potential shortfall from individual and corporation income taxes, TCA interest earnings, video gaming taxes, vehicle fees/taxes, and the remaining sources is combined with the potential excess from oil and gas production taxes, total general fund revenues could be below the HJ 2 revenue estimate for FY 2010 by $182.1 million. Using these trends combined with recent economic and tax return data, FY 2011 general fund revenues could also be below the HJ

2 revenue estimate by $167.8 million. Combined, the total general fund 2011 biennium revenue shortfall could be $349.9 million or about 9.7 percent of the HJ 2 revenue estimates.

Figure 2a

2011 Biennium General Fund Outlook In Millions	Biennium
Legislative Projected Balance	$282.4
FY 2009 Balance Change	5.0
Net Revenue Changes	(349.9)
Fund Balance Adjustments	(0.5)
Supplementals	?
New Projected Balance *	($63.0)

* Before executive spending reduction recommendations

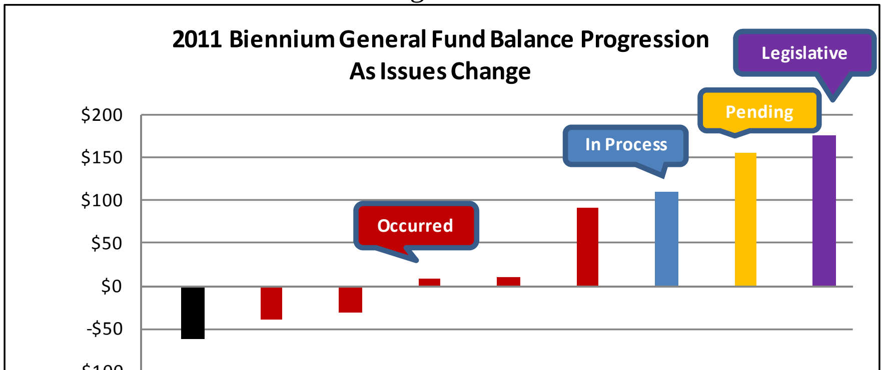
The 61st Legislature adopted a policy to maintain a higher general fund ending fund balance for the 2011 biennium ($282.4 million) in the event of revenue shortfalls. The potential shortfalls discussed above would decrease this projected balance to negative $63.0 million (figure 2a) before the spending reduction proposals of the executive. This projected balance includes the additional $5.0 million received in the FY 2009 ending balance but does not include any supplemental appropriations. Staff is currently researching the need for supplemental appropriations.

The projected balance of negative $63.0 million is mitigated to a positive $81.5 million when the following items are included:

- Tier 1 FMAP
- Federal Clawback
- Executive Spending Reductions
- Legislative and Judicial Spending Reductions
- Otter Creek Bonus Payment

The PPL river bed litigation, federal FMAP extension, and the executive proposal to eliminate some transfers have not been included at this time. As shown in Figure 2b, these issues are pending or require legislative action. Figure 2b shows progression in the projected general fund balance if these issues materialize in the future.

Figure 2b



	Ending Balance	Tier 1 FMAP	Clawback	Spending Reductions	Legislative / Judicial	Otter Creek Lease	PPL River Beds	FMAP Extension	Transfers Elliminated
Est.Amount		$23.1	$8.4	$40.5	$1.2	$81.5	$18.4	$45.0	$21.0
New Balance	($63.0)	($39.9)	($31.5)	$9.0	$10.2	$91.7	$110.1	$155.1	$176.1

As discussed in previous general fund revenue reports, the revenue collection trends have not worsened and have stabilized at the reduced rate projected in February. This is potentially "good news" because it could single that we have reached the bottom of the decline. There are definitely some positive signs that are noteworthy. Withholding tax payments have been improving since February, national corporate profitability is up, consumer spending has improved, and the equity markets have steadily improved until the last week or two. While these indicators may point to a revenue improvement in FY 2011, our revised estimates for FY 2011 anticipated these changes and have already been built into our estimates shown in Figure 1. It is important to note that as revenues fall below expectations, the structural gap (difference between on-going revenues and on-going expenditures) widens thereby creating a significant 2013 biennium budget challenge for the 2011 Legislature.

GENERAL FUND REVENUE UPDATE

FISCAL 2010 REVENUE COLLECTIONS

Based on information recorded on the Statewide Accounting, Budgeting, and Human Resource System (SABHRS), total general fund receipts through May for FY 2010 were $1,217.3 million as shown in Figure 3. This compares to $1,446.3 million collected through May for FY 2009. This is a decline in collections from FY 2009 of $229.0 million or a 15.8 percent decrease.

Total general fund collections as estimated by the legislature for FY 2010 were expected to be $35.1 million (1.9 percent) below the FY 2009 actual collections. These estimates were used by the 61st Legislature and are contained in the adjusted HJ 2 (revenue estimate resolution plus impacts of enacted legislation). Most of this reduction was expected from corporate income tax, oil and gas production tax, and TCA (treasury cash account) investment earnings. Corporation income tax collections were expected to decline because of the impacts of the economic recession on corporate profits. Oil and gas production collections were expected to decline because of significantly reduced commodity prices and reduced production levels. TCA investments earnings were expected to decline because of the historical low level for short-term interest rates. Individual income tax, the largest general fund revenue source, was expected to increase as the effects of the economic recession were expected to subside by the end of FY 2010.

Figure 3 shows revenue collection and estimate data by major revenue category. The last three columns in the figure compare collections from each revenue source to the estimate contained in HJ 2. For example, corporation income tax (10^{th} line) shows a negative $80.4 million in the "Difference" column. This means collections through May of this year are $80.4 million less than the amount received through May of FY 2009 for a negative 55.1 percent difference shown in the "% Change" column. The legislature assumed collections would be down by 30.5 percent shown in the last column.

Figure 3

General Fund Revenue Monitoring Report

Revenue Source	Actual Fiscal 2009	HJ2 Estimate Fiscal 2010	Through 5/31/09	Through 5/31/10	Difference	% Change	HJ2 Estimate % Change
GF0100 Drivers License Fee	3,478,285	3,920,000	3,006,474.19	3,681,152.66	674,678.47	22.44%	12.70%
GF0200 Insurance Tax	50,038,468	58,762,000	38,232,723.28	39,110,163.68	877,440.40	**2.29%**	17.43%
GF0300 Investment Licenses	6,461,446	6,210,000	6,020,670.20	5,904,603.04	(116,067.16)	-1.93%	-3.89%
GF0400 Vehicle License Fee	89,334,878	92,247,000	68,182,770.78	69,767,280.39	1,584,509.61	**2.32%**	3.26%
GF0500 Vehicle Registration Fee	15,345,099	17,970,000	12,017,598.10	10,636,858.36	(1,380,739.74)	**-11.49%**	17.11%
GF0600 Nursing Facilities Fee	5,468,766	5,213,000	4,084,100.91	3,968,307.29	(115,793.62)	-2.84%	-4.68%
GF0700 Beer Tax	3,114,729	3,218,000	2,545,381.00	2,504,586.77	(40,794.23)	**-1.60%**	3.32%
GF0800 Cigarette Tax	34,320,412	32,007,000	29,797,739.18	27,973,367.41	(1,824,371.77)	-6.12%	-6.74%
GF0900 Coal Severance Tax	13,028,228	10,846,000	10,025,680.69	8,103,170.07	(1,922,510.62)	**-19.18%**	-16.75%
GF1000 Corporation Tax	166,354,514	115,638,000	145,982,523.99	65,532,963.42	(80,449,560.57)	**-55.11%**	-30.49%
GF1100 Electrical Energy Tax	4,824,659	4,717,000	3,696,162.81	3,320,502.94	(375,659.87)	**-10.16%**	-2.23%
GF1150 Wholesale Energy Trans Tax	3,864,771	3,931,000	3,000,878.59	2,786,712.08	(214,166.51)	**-7.14%**	1.71%
GF1200 Railroad Car Tax	2,099,454	2,295,000	2,036,051.05	2,579,262.89	543,211.84	26.68%	9.31%
GF1300 Individual Income Tax	815,138,193	840,263,000	715,643,636.02	595,586,018.71	(120,057,617.31)	**-16.78%**	3.08%
GF1400 Inheritance Tax	217,097	29,000	174,859.67	87,104.18	(87,755.49)	-50.19%	-86.64%
GF1500 Metal Mines Tax	5,992,923	3,248,000	2,818,391.21	3,455,753.62	637,362.41	22.61%	-45.80%
GF1700 Oil Severance Tax	100,490,971	66,930,000	65,055,130.93	45,506,077.61	(19,549,053.32)	-30.05%	-33.40%
GF1800 Public Contractor's Tax	5,929,999	4,322,000	4,556,532.05	5,412,304.10	855,772.05	18.78%	-27.12%
GF1850 Rental Car Sales Tax	2,904,340	3,182,000	2,305,498.50	2,205,428.45	(100,070.05)	**-4.34%**	9.56%
GFxxxx Property Tax	217,042,057	228,853,000	131,971,206.58	136,036,056.43	4,064,849.85	**3.08%**	5.44%
GF2150 Lodging Facilities Sales Tax	12,477,461	13,376,000	9,598,628.34	9,060,726.43	(537,901.91)	**-5.60%**	7.20%
GF2200 Telephone Tax	-	-	-	-	-		
GF2250 Retail Telecom Excise Tax	22,250,383	21,672,000	14,005,400.32	14,412,234.86	406,834.54	2.90%	-2.60%
GF2300 Tobacco Tax	4,990,497	4,738,000	4,096,127.13	4,462,180.28	366,053.15	8.94%	-5.06%
GF2400 Video Gaming Tax	62,458,106	69,003,000	47,120,622.18	39,819,234.46	(7,301,387.72)	**-15.50%**	10.48%
GF2500 Wine Tax	1,936,052	2,043,000	1,621,379.89	1,612,082.19	(9,297.70)	**-0.57%**	5.52%
GF2600 Institution Reimbursements	14,100,804	16,047,000	11,066,685.00	16,983,847.32	5,917,162.32	53.47%	13.80%
GF2650 Highway Patrol Fines	4,179,882	4,055,000	3,457,042.27	3,915,341.73	458,299.46	13.26%	-2.99%
GF2700 TCA Interest Earnings	15,506,889	7,967,000	14,405,484.58	2,249,853.69	(12,155,630.89)	**-84.38%**	-48.62%
GF2900 Liquor Excise Tax	12,650,902	16,581,000	12,763,967.30	9,852,710.26	(2,911,257.04)	**-22.81%**	31.07%
GF3000 Liquor Profits	7,250,000	7,039,000	-	-	-		-2.91%
GF3100 Coal Trust Interest Earnings	26,958,378	28,574,000	19,936,000.93	20,421,272.05	485,271.12	**2.43%**	5.99%
GF3300 Lottery Profits	10,136,213	10,969,000	5,480,013.00	5,558,657.00	78,644.00	**1.44%**	8.22%
GF3450 Tobacco Settlement	4,127,609	4,007,000	4,127,609.08	3,468,623.20	(658,985.88)	**-15.97%**	-2.92%
GF3500 U.S. Mineral Leasing	31,573,364	27,796,000	25,301,903.79	20,591,338.08	(4,710,565.71)	**-18.62%**	-11.96%
GF3600 All Other Revenue	31,921,805	35,247,000	22,168,130.17	30,764,631.22	8,596,501.05	38.78%	10.42%
Grand Total	1,807,967,634	1,772,915,000	1,446,303,003.71	1,217,330,406.87	(228,972,596.84)	**-15.83%**	-1.94%

* Plus impacts of enacted legislation

DISCUSSION OF SELECTED SOURCES FOR FISCAL 2010 AND FISCAL 2011

The following section of the report addresses some of the key general fund revenue sources that were monitored closely during the regular session. These sources are individual income tax, corporation income tax, treasury cash account (TCA) interest earnings, and oil and gas production tax. These sources were chosen because of their vulnerability to the economic recession and the discussion these sources received during the past legislative session. This section of the report also includes a discussion on sources that are showing very unusual collection patterns. These sources are insurance taxes, vehicle fees/taxes, liquor excise taxes, and video gaming taxes. As discussed in the September report, cigarette taxes and US mineral leasing revenues were lagging the HJ 2 estimate because of an accrual and revenue deposit timing issues, respectively. These issues have been resolved and the revenues are now more comparable to historical patterns.

Individual Income Tax

Based on May accounting data, net individual income tax collections for FY 2010 (gross collections less refunds) were 16.8 percent below net collections for FY 2009 or a decrease of $120.1 million. The 61st Legislature assumed that revenues would increase by 3.1 percent from the FY 2009 amount or an increase of $25.1 million. This increase was anticipated because the effects of the economic recession were expected to subside by the end of FY 2010.

Figure 4 shows the accounting details through May of individual income tax collections for FY 2010 compared to the same period for FY 2009. Since withholding tax collections are a proxy of total wage growth, the negative 0.9 percent growth from last year indicates total wages have declined from the level observed a year ago. It should be noted, however, that the rate of decline has improved from last month (negative 1.0 percent). The most recent state unemployment rate has edged up slightly. This means the rate of decline in withholding payments will probably not change significantly in the near term. Withholding payments for mineral royalties have declined by $4.0 million or 26.3 percent. This decline was anticipated because of the significant reduction in Montana's wellhead oil price.

Figure 4

Individual Income Tax Comparison

Revenue Code & Description	Through 5/31/2009 Fiscal 2009	Through 5/31/2010 Fiscal 2010	Difference	Percent Change
510101 Withholding Tax	569,292,406.94	564,091,691.40	(5,200,715.54)	-0.91%
510482 Mineral Royalty WH Tax	15,120,673.95	11,145,495.52	(3,975,178.43)	-26.29%
510102 Estimated Tax	218,055,733.19	150,143,354.91	(67,912,378.28)	-31.14%
510103 Current Year I/T	128,414,815.97	104,155,821.07	(24,258,994.90)	-18.89%
510105 Income Tax - Audit Collections	23,998,135.00	28,433,066.00	4,434,931.00	18.48%
510106 Income Tax Refunds	(239,238,129.03)	(143,021,438.02)	96,216,691.01	-40.22%
Income Tax Refunds Adjustment	0.00	(119,361,972.17)	(119,361,972.17)	
Totals	$715,643,636.02	$595,586,018.71	($120,057,617.31)	-16.78%
Percent of Actual/Estimated	82.58%	70.88%		

Estimated payments, after three quarterly payments, were $67.9 million (31.1 percent) below last year. During the last two quarters of FY 2009, estimated payments declined by 14.5 and 33.6 percent, respectively. Review of FY 2010 payments shows a continuation of this trend. With a substantial drop in the equity markets during late 2008 and early 2009, historical low interest rates, and reductions in corporate profitability, it is not surprising to observe a significant reduction in estimated payments. Estimated payments and current year payments are a good indicator of how taxpayers' non-wage components of income are changing relative to economic conditions.

Figure 4a

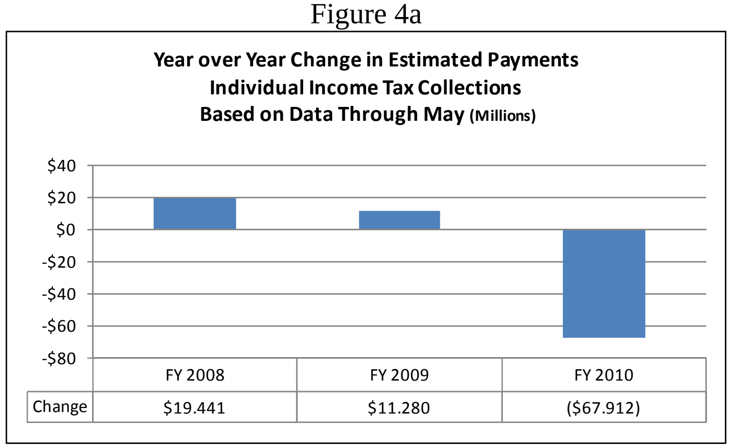
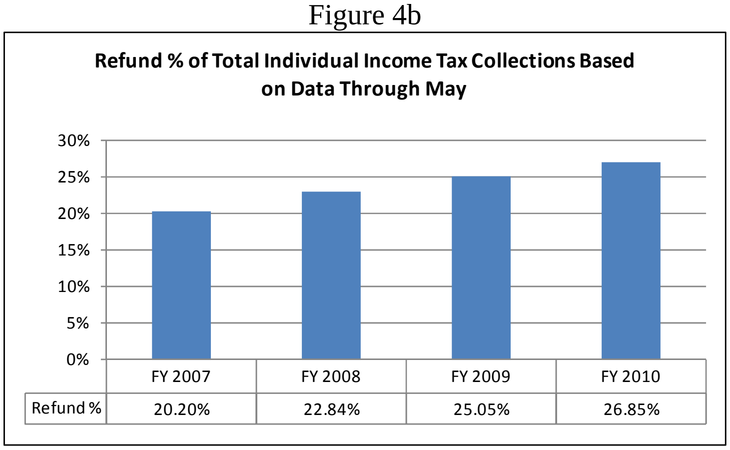


Figure 4a shows year over year change in estimated payments from FY 2008 to FY 2010. As shown, estimated payments have dropped off significantly when compared to the two previous years. The next payment, due on June 15th, will probably be similar to the payment received on April 15th.

Figure 4 shows two lines for individual income tax refunds. Because of a legislative audit recommendation, the DOR processed a refund payable adjustment in October that was previously recorded during the fiscal year-end adjustment period. By including the adjustment amount in Figure 4, total collections between fiscal years continue to be an "apples to apples" comparison. Without the refund adjustment amount, refunds through May would have shown a negative $143.0 million, an amount not comparable to the negative $239.2 million shown for FY 2009. This refund adjustment will be shown in subsequent months to maintain comparability with last year.

Since October 15, 2009 was the due date for tax returns that were extended beyond the April 15th due date, refunds issued by the end of May are an indication of under or overpayment of taxes during FY 2009 plus the trends for this tax season. As stated in previous reports, if refunds issued by December 31st were unusually high, this would indicate taxpayers overpaid during FY 2009 thereby inflating actual receipts for FY 2009. Conversely, if refunds were unusually low, taxpayers underpaid during FY 2009 which would mean FY 2009 receipts were understated. As of the end of May, refunds (the two refund lines combined) were $262.4 million or $23.1 million (9.7 percent) above the same period for FY 2009. The data suggests that refunds are higher for this tax season and taxpayers overpaid their taxes during FY 2009, thereby overstating FY 2009 total collections. This is an unfavorable trend for FY 2010 since overpayments in FY 2009 mean the income base is lower than originally assumed by the legislature. If the income base is lower, then growth from FY 2009 to FY 2010 needs to be stronger in order to achieve the HJ 2 estimate. Figure 4b shows refunds as a percent of total individual income tax collections. As shown, the refund percent has increased from previous years. It should be noted, however, that the difference in the percentages between this year and last year has steadily decreased during the current tax season. This is an indication that refunds issued are more consistent with historical patterns and that the higher percentages observed in the earlier months were due to economic conditions as well as taxpayers utilizing electronic filing.

Figure 4b



When all of the accounting categories are added together, total individual income tax collections through May are $120.1 million below FY 2009 amounts. Since total FY 2010 collections were estimated to be $25.1 million (3.1 percent) above FY 2009 amounts, the HJ 2 individual income tax estimate for FY 2010 is overstated. As previous mentioned, however, collection patterns indicate individual income tax revenues may be worse than original projected in February. Instead of $118 million and $95 million below the HJ2 estimate for FY 2010 and 2011, respectively, the shortfall could be $133 million and $110 million respectively.

Corporation Income Tax

Based on May accounting data, net corporation income tax collections for FY 2010 (gross collections less refunds) were 55.1 percent below net collections for FY 2009 or a decrease of $80.4 million (Figure 5). The 61st Legislature assumed that revenues would decrease by 30.5 percent from the FY 2009 amount or a decrease of $50.7 million. This decrease was anticipated because of the effects the economic recession on corporate profitability for both state and national corporations.

As pointed out in previous reports, part of the strength in FY 2009 collections was explained by the auditing efforts of the DOR and the resulting unusual high audit collections. Total audit collections were $31.0 million in FY 2009 compared to $16.9 million in FY 2008. When audit collections are removed from FY 2008 and 2009 totals, then the trend for the remaining collections are a negative 5.7 percent, a decline rate greater than estimated in HJ 2 for FY 2009. The good news is that audit collections in FY 2010 continue to be strong, $13.5 million. This amount represents 17.0 percent of total corporation income tax collections through May but is $11.3 million less than received through May of FY 2009. An unusually large audit payment was received in January 2009.

Estimated payments, after three quarterly payments, were $39.3 million (42 3 percent) below last year. Further review of tax payment detail by corporation provides some additional insight into estimated payments. Similar to individual income tax, estimated payments for the last two quarters of FY 2009 declined by 34.9 and 41.3 percent, respectively. Review of FY 2010 payments shows a continuation of this trend. With announced job layoffs, business closures and/or cutbacks, significant consumer spending reductions, and construction plummeting, it is not surprising to observe a significant reduction in estimated payments.

Figure 5

Corporation Income Tax Comparison

Revenue Code & Description	Through 5/31/2009 Fiscal 2009	Through 05/31/2010 Fiscal 2010	Difference	Percent Change
510501 Corporation Tax	48,728,966.88	31,793,392.75	(16,935,574.13)	-34.75%
510505 Corporation Tax Estimated Paym	92,811,570.55	53,561,038.64	(39,250,531.91)	-42.29%
510502 Corporation Tax Refunds	(20,351,830.44)	(30,456,862.32)	(10,105,031.88)	49.65%
510503 Corporation Tax-Audit Collect.	24,793,817.00	13,463,151.00	(11,330,666.00)	-45.70%
Corporation Tax Refunds Adjustment	0.00	(2,827,756.65)	(2,827,756.65)	
Totals	$145,982,523.99	$65,532,963.42	($80,449,560.57)	-55.11%
Percent of Actual/Estimated	91.04%	56.67%		

Figure 5a shows year over year change in estimated payments from FY 2008 to FY 2010. As shown, estimated payments have dropped off significantly when compared to the two previous years. The next payment, due on June 15th, will probably be similar to the payment received on April 15th.

Figure 5a

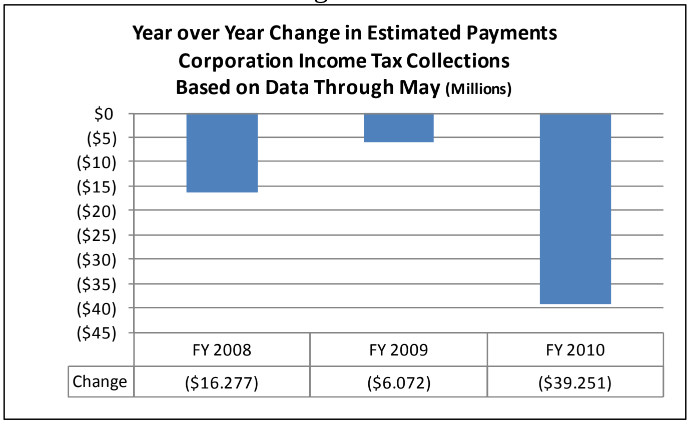
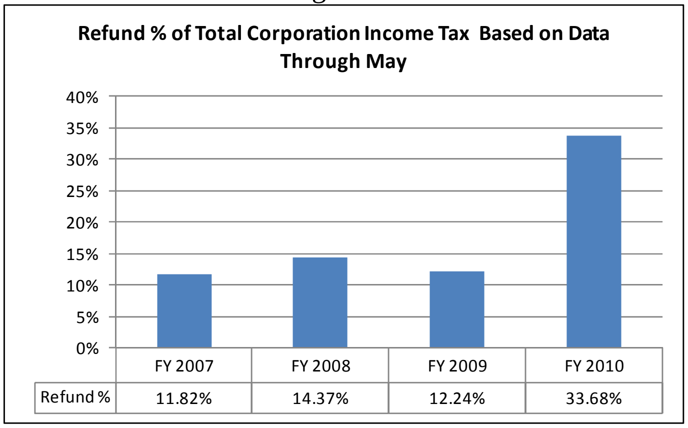


Figure 5 shows two lines for corporation income tax refunds. Because of a legislative audit recommendation, the DOR processed a refund payable adjustment in October that was previously recorded during the fiscal year-end adjustment period. By including the adjustment amount in Figure 5, total collections between fiscal years continue to be an "apples to apples" comparison. Without the refund adjustment amount, refunds through May would have shown a negative $30.5 million instead of a negative $33.3 million (the two refund amounts added together). By showing the refund adjustment, total refunds have increased by 63.5 percent compared to last year. This suggests that corporate taxpayers are carrying back losses that result in increased refunds. It may also indicate corporate taxpayers overpaid their taxes during FY 2009 thereby overstating FY 2009 total collections. Figure 5b shows refunds as a percent of total corporation income tax collections. As shown, the refund percent has increased significantly from previous years.

Figure 5b



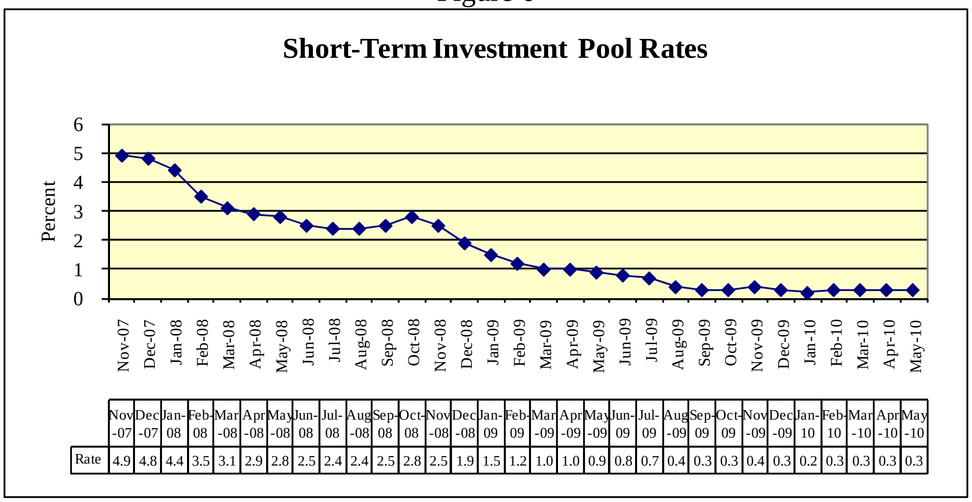
When all of the accounting categories are added together, total corporation income tax collections through May are $80.4 million or 55.1 percent below FY 2009. Since total FY 2010 collections were estimated to be $50.7 million (30.5 percent) below FY 2009 amounts, the HJ 2 corporation income tax estimate for FY 2010 is overstated. As previous mentioned, however, collection patterns indicate corporation tax revenues may be better than original projected in February. Instead of $58 million and $53 million below the HJ2 estimate for FY 2010 and 2011, respectively, the shortfall could be $43 million and $38 million.

Treasury Cash Account (TCA) Interest Earnings

Based on May accounting data, TCA interest earnings for FY 2010 were 84.4 percent below collections for FY 2009 or a decrease of $12.2 million. The 61st Legislature assumed that revenues would decrease by 48.6 percent from the FY 2009 amount or a decrease of $7.5 million. This decrease was anticipated because of the reduced rate of return anticipated for short-term securities.

For FY 2009, collections from this source were below estimate by $1.0 million or 6.1 percent. This trend is much worse in FY 2010 as collections are down 84.4 percent when May's collections of FY 2009 are compared to the same period of FY 2010. Since TCA interest earnings are based on cash available for investment and the rate of return for short-term securities, reduced earnings are primarily due to reduced short-term interest rates. Figure 6 shows the average monthly rate of return received on the short-term investment pool (STIP) as published by the Board of Investments since November 2007. Short-term rates have plummeted from 4.9 percent in November 2007 to 0.32 percent in May 2010.

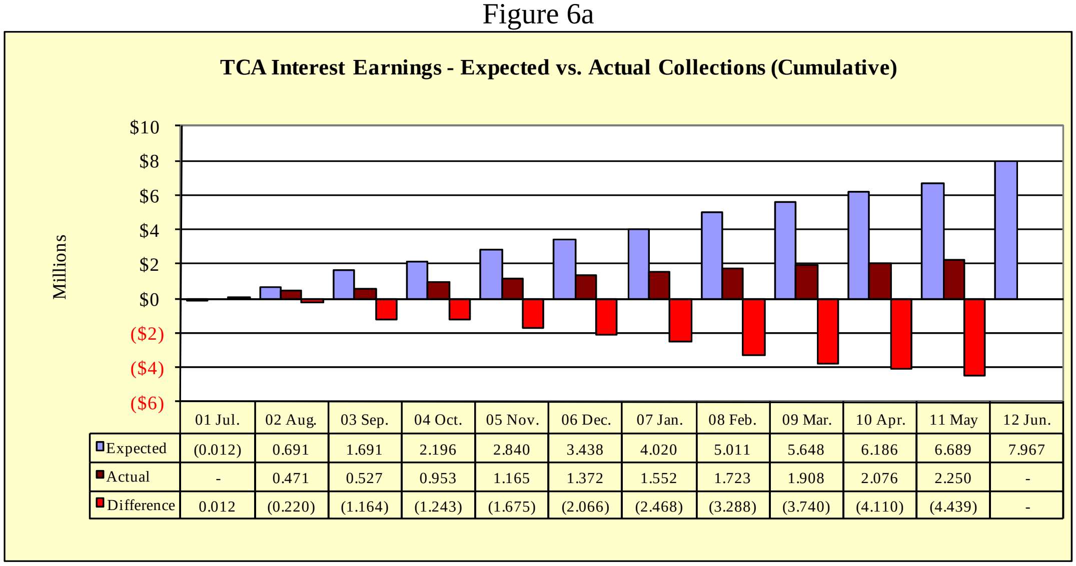
Figure 6



	Nov-07	Dec-07	Jan-08	Feb-08	Mar-08	Apr-08	May-08	Jun-08	Jul-08	Aug-08	Sep-08	Oct-08	Nov-08	Dec-08	Jan-09	Feb-09	Mar-09	Apr-09	May-09	Jun-09	Jul-09	Aug-09	Sep-09	Oct-09	Nov-09	Dec-09	Jan-10	Feb-10	Mar-10	Apr-10	May-10
Rate	4.9	4.8	4.4	3.5	3.1	2.9	2.8	2.5	2.4	2.4	2.5	2.8	2.5	1.9	1.5	1.2	1.0	1.0	0.9	0.8	0.7	0.4	0.3	0.3	0.4	0.3	0.2	0.3	0.3	0.3	0.3

Figure 6a shows TCA interest earnings through May (cumulative) versus the HJ 2 annual revenue estimate allocated by month. As shown in Figure 6a, TCA interest earnings are not keeping pace with the HJ 2 estimate and are lagging the estimate more each month. Based on these trends, TCA interest earnings could be below the HJ 2 estimate by at least $4.5 million for FY 2010 and $6.4 million in FY 2011. The probability of a larger decline is quite high.

Figure 6a



	01 Jul.	02 Aug.	03 Sep.	04 Oct.	05 Nov.	06 Dec.	07 Jan.	08 Feb.	09 Mar.	10 Apr.	11 May	12 Jun.
Expected	(0.012)	0.691	1.691	2.196	2.840	3.438	4.020	5.011	5.648	6.186	6.689	7.967
Actual	-	0.471	0.527	0.953	1.165	1.372	1.552	1.723	1.908	2.076	2.250	-
Difference	0.012	(0.220)	(1.164)	(1.243)	(1.675)	(2.066)	(2.468)	(3.288)	(3.740)	(4.110)	(4.439)	-

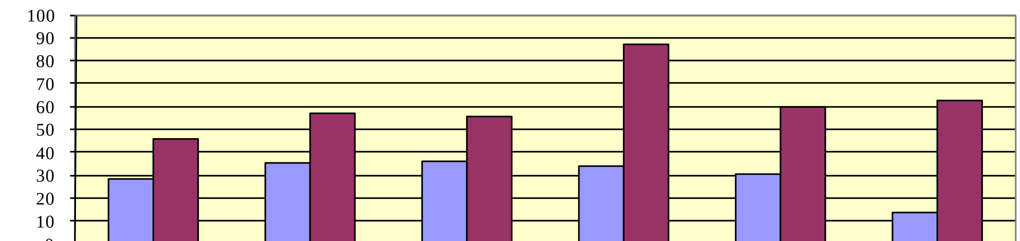
Oil and Gas Production Tax

Oil and natural gas production taxes are one of the major sources of revenue that could exceed the HJ 2 estimate. As shown in Figure 3 (page 4), oil and gas production tax collections through May FY 2010 are below FY 2009 collections by $19.5 million. This was expected because oil and gas prices were significantly higher for the first two quarters of FY 2009 versus FY 2010. The most recent tax return data as filed with the DOR provide information on production and wellhead prices for FY 2009 and the first two quarters of FY 2010. As shown in Figure 6b, oil production in Montana was 30.6 million barrels at an average price of $59.55 per barrel for FY 2009. The estimates contained in HJ 2 were for production to be 30.1 million barrels at an average price of $54.36 per barrel.

As shown in Figure 6b, total oil production for the first two quarters of FY 2010 was 13.4 million barrels. If production continues at this rate for the remaining two quarters, FY 2010 production would be 26.8 million barrels. The estimated production contained in HJ 2 is 27.4 million barrels for FY 2010.

Using the production estimate contained in HJ 2 for FY 2010 (27.4 million barrels) and a price assumption of $62.91 per barrel (approximate current price), general fund oil production tax revenue in FY 2010 would exceed the HJ 2 estimate by approximately $29 million. General fund natural gas production tax, on the other hand, could be below the HJ 2 estimate by as much as $8 million. Natural gas production and prices are currently well below the HJ 2 assumptions for FY 2010. When combined, oil and natural gas production revenue could be $21 million above the HJ 2 estimate for FY 2010 and $12 million for FY 2011.

Figure 6b



	2005	2006	2007	2008	2009	2010:Q1&Q2
Barrels	28.643	35.097	36.201	33.797	30.578	13.376
Price	$45.56	$57.33	$55.84	$87.30	$59.55	$62.91

Unusual Collection Patterns

As shown in Figure 3, several sources of revenue are showing unusual collection patterns other than those sources previously discussed. Some of the larger sources are insurance taxes, vehicle fees/taxes, liquor excise taxes, and video gaming taxes.

Insurance Taxes

The insurance tax collection variation shown in previous reports is no longer an issue. Previous receipt fluctuations were due to the timing of deposits this year versus previous years. Historically, the first estimated payment for insurance taxes is deposited either in October or November. As shown in Figure 7, the first estimated payment for FY 2007 was recorded in October while the first payment was recorded in November for FY 2008 and FY 2009. This fiscal year, the first estimated payment was deposited in September. In addition, the second estimated payment for FY 2010 was recorded in December. Historically, this payment was deposited in January or in February as was the case in FY 2009. The third estimated payment was deposited in April this year versus May for FY 2007 and FY 2009.

It should be noted that collections shown for FY 2010 reflect the reduced insurance tax deposits to the general fund because of the passage of Initiative 155 and the subsequent modification of statute in HB 676 by the 61st Legislature.

Initiative 155 allocated 33 percent of the insurance tax to the Healthy Montana Kids account. HB 676, enacted after Initiative 155, reduced the insurance tax distribution to the Healthy Montana Kids account from 33 percent to 16.67 percent and allocated the difference to the general fund. This legislation was effective July 1, 2009, and the section changing the percentage distribution of insurance taxes terminates June 30, 2013.

Figure 7

Insurance Tax Collections				
Month	Actual FY 2007	Actual FY 2008	Actual FY 2009	Actual FY 2010
01 Jul.	-	-	-	85,036.88
02 Aug.	17,351.87	142,074.46	(66,186.21)	426,556.78
03 Sep.	706,428.30	523,190.61	10,629.00	***11,448,689.03***
04 Oct.	***11,847,042.80***	(64.05)	72,949.25	30,688.53
05 Nov.	551,560.59	***13,221,557.58***	***14,049,612.52***	292,115.31
06 Dec.	429,657.82	236,967.83	22,597.79	***11,305,965.43***
07 Jan.	**12,305,424.58**	***8,153,338.01***	*20,609.00*	270,249.86
08 Feb.	4,763.50	109,654.50	***9,529,622.13***	301,391.85
09 Mar.	509,902.53	***7,412,384.35***	375,272.62	2,379,549.79
10 Apr.	(95,217.23)	638,047.72	1,224,430.55	***13,379,462.27***
11 May.	***18,541,995.29***	(52,267.42)	***12,993,186.63***	1,589,819.75
Total	**$44,818,910.05**	**$30,384,883.59**	**$38,232,723.28**	**$41,509,525.48**

Vehicle Fees/Taxes

During September 2009, our office contacted the Department of Justice (DOJ) regarding vehicle fees/taxes. At that time, DOJ personnel indicated that the interface between MERLIN (the new DOJ vehicle system) and SABHRS was not totally working correctly. DOJ personnel assured LFD staff that by the end of October, general fund collections for motor vehicle fees/taxes would be adjusted to reflect correct collections to date. Near the end of October, DOJ staff contacted our office to inform us of further unresolved issues and that the correcting adjustments would not be completed by the end of October. On December 31st, the DOJ staff informed our office that the department had successfully processed the accounting transaction backlog except for approximately $2.5 million in uncleared collections. The DOJ staff indicated that collections through December 2009 should be comparable to December 2008 collections.

As shown in Figure 8, total vehicle fees/taxes as recorded on SABHRS are $0.2 million above last year's amount as of the end of May. This is a complete reversal of patterns observed in previous months. Because MERLIN was implemented at this time last year, it is still inappropriate to use accounting information to speculate on these trends. Based on information received from the DOJ, revenue from this source could be below the HJ 2 estimate by $7.0 million in FY 2010 and $4.8 million in FY 2011. Staff does think there is a high probability that revenue collections from this source could be better than anticipated in February.

Figure 8

Vehicle Fee/Tax Collections and Estimates					
Revenue Category	Actual FY 2009	HJ 2 Estimate FY 2010	Through May FY 2009	Through May FY 2010	Change
GF0400 Vehicle License Fee	89,334,878	92,247,000	68,182,771	69,767,280	1,584,509
GF0500 Vehicle Registration Fee	15,345,099	17,970,000	12,017,598	10,636,858	(1,380,740)
Total Vehicle Fees/Taxes	**$104,679,977**	**$110,217,000**	**$80,200,369**	**$80,404,138**	**$203,769**

Liquor Excise Taxes

Liquor excise tax collections through May 2010 are not comparable to the same period of 2009. This is because of an accounting procedure change implemented by the DOR due to an audit recommendation by the Legislative Auditor. Our office requested the Legislative Audit Division (LAD) to review the procedures implemented by the department to determine whether these changes conform to appropriate accounting principles. LAD has reviewed these procedures and has discussed their findings with DOR personnel. At this time, liquor excise tax collections are expected to lag last year's collections until fiscal year end when collections should be more comparable between fiscal years.

Video Gaming Taxes

The video gaming tax collection variation is due to the timing of deposits this year versus previous years and also a decline in machine play. Historically, the first payment for video gaming taxes is deposited in July and/or August as shown in Figure 9. The revenue accrual reversal (shown as negative) should occur in October per state accounting policy. Figure 9 shows the accrual reversal did not occur until November in FY 2008 and not until December in FY 2010. The accrual reversal did not occur until February in FY 2009.

As mentioned in previous reports, a decrease in collections was noted during the legislative session but it was premature to assess the trend until further collection activity was received. For FY 2009, collections from this source were below estimate by $4.1 million or 6.2 percent. This downturn trend has continued into FY 2010. After adjusting for the deposit anomalies discussed above, video gaming tax collections are lagging FY 2009 amounts by $7.3 million or 15.5 percent. On an annual basis, the shortfall for FY 2010 is expected to be at least $11.5 million and may be closer to $15 million. A similar trend is expected in FY 2011 with an additional shortfall of $11.1 million to $14.6 million. Since video gaming tax revenues are based on gross income (defined as net of payouts), reduced tax revenues are due to less machine play. This suggests that individuals have less to spend (economic recession impacts) or are choosing to spend their disposable income on other items or to increase savings. The additional factor that has impacted video gaming tax collections is the passage of the smoking ban which went into effect on October 1, 2009.

Figure 9

Video Gaming Tax Collections

Month	Actual FY 2008	Actual FY 2009	Actual FY 2010
01 Jul.	6,723,404.94	15,982,192.05	15,334,630.29
02 Aug.	8,642,589.97	8,339.34	7,678.82
03 Sep.	24,045.75	56,439.70	75,826.60
04 Oct.	14,726,602.92	15,793,382.36	14,543,265.35
05 Nov.	(14,182,034.95)	(39,493.32)	409,568.80
06 Dec.	15,602.75	88,608.80	(15,198,697.62)
07 Jan.	15,345,436.50	15,163,868.67	12,309,438.70
08 Feb.	658,327.95	(15,551,717.75)	38,560.62
09 Mar.	50,102.84	111,208.48	98,159.85
10 Apr.	14,952,634.70	15,520,052.10	12,181,947.55
11 May.	582,913.60	(12,258.25)	18,855.50
Total	**$47,539,626.97**	**$47,120,622.18**	**$39,819,234.46**

In conclusion, unusual collection patterns can skew total general fund revenues when comparisons are made from month to month. All of these anomalies have been considered when determining the anticipated revenue shortfall shown in Figure 1. Our office will continue to monitor these issues further as well as any new issues before the next report.

SUMMARY

Total general fund revenue collections through May for FY 2010 are below the same period of FY 2009 by $229.0 million or 15.8 percent. The 61st Legislature assumed revenue would decline by only 1.9 percent from FY 2009 to FY 2010 or $35.1 million. This means that total collections are $193.9 million below the HJ 2 estimate for FY 2010. As shown in Figure 1, our current estimate of the anticipated shortfall is $182.1 million. The probability that the shortfall will improve materially in one month is quite low. Even though some of the improvements in economic conditions have been noted previously, tax revenue improvements do not respond immediately because of the inherit nature of statutory payment schedules.

The focus of this analysis was on individual income tax, corporation income tax, TCA interest earnings, oil and gas production tax, and sources with unusual collection patterns. Since individual income tax is the predominate source of revenue in the general fund account, a small percentage change in this source can have a significant impact on total general fund revenues. As detailed in the report, however, accounting data for eleven months of the fiscal year combined with new economic and tax return data show that individual and corporation income tax revenues, TCA interest earnings, video gaming taxes, vehicle fees/taxes, and all remaining sources could be below the HJ 2 estimate by $203.4 million for FY 2010 and an additional $180.1 million for FY 2011. Conversely, oil and gas production tax revenue could exceed the HJ 2 estimate by as much as $33.6 million for the biennium if prices exceed $62.73 per barrel and production does not fall below the HJ 2 estimate.

The previous reports indicated that collections were lagging expectations and that the lag in collections would have to be "made up" in subsequent months in order to achieve the HJ 2 estimated level. Collections through May have not improved but our analysis suggests revenue estimate adjustments are not warranted at this time. It should be noted, however, that unusual collection patterns for the sources discussed previously can skew the total general fund collections from month to month. These unusual collection patterns have been accounted for in the summary information shown in Figure 1 on page 1. Your staff will continue to research each of these issues and any other issues before the next report is issued. That report will highlight collections through the end of June

Attachment 1 and 2 are pages first added to the monthly updates on general fund revenue collections in November 2009. Attachment 1 shows a variety of important economic and revenue indicators for Montana. For example, if you are interested in price and production statistics for Montana's natural resource industry, this document shows oil, coal, and natural gas data for the last completed two years. For each statistic shown, the data source, measurement unit, whether the information is by calendar or fiscal year, an amount for 2008 and 2009, change amount, and percentage change is provided. The purpose of this information is to provide the reader with some relevant data on Montana's economic climate.

Attachment 2 shows a summary of the general fund cash balance flow by month, current year revenue collections and disbursements by month, and cumulative current year revenue collections and disbursements by month. These summaries provide an insight to the fluctuations in cash balances as well as the variances between monthly revenues and disbursements. Particular attention should be given to the first figure in attachment 2. The beginning cash balance for FY 2010 was $446.4 million. This balance has declined by $279.8 million to $166.6 million after eleven months of FY 2010. Ending fund balance is always the focal point in budget deliberations but it takes cash to pay for the services provided by state government. The cash balance is a key number to watch in subsequent monthly updates.

The third figure on attachment 2 shows cumulative revenues and expenditures by month for FY 2010. This figure indicates that revenues are being collected at a slower rate than the expenditures for state services. The reason this can occur is because of the large carry forward cash balance from FY 2009.

Attachment 3 is a "Perspective Article" on the US economy as prepared by IHS Global Insight (GI). As you may recall, GI is the national economic forecasting firm the state contracts with to provide economic forecasts.

This article is a GI perspective on Fed Chairman Bernanke testimony to the U.S. House Budget Committee on June 9th. The following is an excerpt that was extracted from the "Perspective Article":

Finally, Bernanke issued a strongly issued warning on long-term U.S. fiscal sustainability. Even after economic and financial conditions return to normal, the federal budget is on an unsustainable path—the aging of the U.S. population will put severe strains on Social Security and healthcare spending.

The Fed chairman closed with a stern warning "unless we make a strong commitment to fiscal responsibility, in the longer run, we will have neither financial stability nor healthy economic growth."

To put this statement in perspective, Montana funds approximately 40 percent (about $2 billion per year) of governmental services with federal dollars. A one percent reduction in federal funding equates to a reduction in funding of $20 million for each percent reduction.

Attachment 1 – Economic & Revenue Indicators

Group	Statistic	Source*	Unit	Year Type	2008	2009	Change Amount	Percent Change
General Economy Indicators								
	MT Wage and Salary Income ($Q:_{1-4}$ to $Q:_{1-4}$)	BEA	Dollars	Calendar	$15,605,000	$15,314,000	($291,000)	-1.86%
	MT Non-Farm Employment ($Q1_{2009}$ to $Q1_{2010}$)	DOL	Count	Calendar	420,933	414,733	(6,200)	-1.47%
	US Consumer Price Index ($Q1_{2009}$ to $Q1_{2010}$)	DOL	Index	Calendar	212.0	217.0	5.0	2.36%
	MT Housing Starts (SAAR) ($Q1_{2009}$ to $Q1_{2010}$)	IHS	Count	Calendar	1,280	1,510	230	17.97%
	MT Existing Home Sales ($Q1_{2009}$ to $Q1_{2010}$)	IHS	Count	Calendar	17,600	20,200	2,600	14.77%
	MT Agricultural Cash Receipts (2007 to 2008)	BEA	Dollars	Calendar	$2,646,477,000	$3,063,104,000	$416,627,000	15.74%
	MT Statewide Taxable Values (2009 to 2010)	DOR	Dollars	Fiscal	$2,137,780,356	$2,192,158,238	$54,377,882	2.54%
	MT Short-Term Investment Pool (STIP) Rate	BOI	Percent	Fiscal	4.49%	1.74%	-2.75%	-61.25%
	MT Trust Funds Bond Pool Rate	LFD	Percent	Fiscal	5.57%	5.54%	-0.03%	-0.54%
Natural Resources								
	Montana Oil Production (Taxable)	DOR	Barrels	Fiscal	33,797,104	30,578,148	($3,218,956)	-9.52%
	Montana Oil Wellhead Price	DOR	$'s/Barrel	Fiscal	$87.30	$59.55	($27.75)	-31.79%
	Montana Coal Production (Taxable)	DOR	Tons	Fiscal	37,404,304	35,807,130	(1,597,174)	-4.27%
	Montana Coal Price (Contract Price)	DOR	$'s/Ton	Fiscal	$8.13	$8.78	$0.64	7.89%
	Montana Natural Gas Production (Taxable)	DOR	MCF's	Fiscal	119,469,640	109,552,742	(9,916,897)	-8.30%
	Montana Natural Gas Wellhead Price	DOR	$'s/MCF	Fiscal	$6.54	$4.41	($2.13)	-32.59%
Consumption								
	Cigarettes Sold (Taxable)	DOR	Packs	Fiscal	50,306,100	48,146,775	(2,159,325)	-4.29%
	Other Tobacco Products (Value)	DOR	Dollars	Fiscal	5,509,042	6,304,569	$795,527	14.44%
	Other Tobacco Products (Roll)	DOR	Ounces	Fiscal	2,674,010	2,631,629	(42,382)	-1.58%
	Other Tobacco Products (Moist)	DOR	Ounces	Fiscal	8,777,115	8,989,006	211,892	2.41%
	Lottery Ticket Sales	SABHRS	Dollars	Fiscal	$43,821,752	$43,826,879	$5,127	0.01%
	Video Gaming Net Income	Computed	Dollars	Fiscal	$420,893,335	$416,387,371	($4,505,963)	-1.07%
	Liquor Sales	DOR	Dollars	Fiscal	$86,480,196	$89,781,906	$3,301,710	3.82%
	Beer Produced/Imported	DOR	Barrels	Fiscal	973,346	990,269	16,923	1.74%
	Wine Imports	DOR	Liters	Fiscal	10,010,357	10,600,521	590,164	5.90%
	Rental Vehicle Sales (Taxable)	DOR	Dollars	Fiscal	$82,195,538	$75,932,842	($6,262,696)	-7.62%
	Lodging Facility Sales (Taxable)	DOR	Dollars	Fiscal	$465,811,003	$442,862,447	($22,948,556)	-4.93%
	Gasoline Gallons (Taxable)	DOT	Gallons	Fiscal	495,175,969	483,073,024	(12,102,945)	-2.44%
	Diesel Gallons (Taxable)	DOT	Gallons	Fiscal	266,624,089	249,174,745	(17,449,344)	-6.54%

Source *

BEA - US Department of Commerce, Bureau of Economic Analysis
DOL - Montana Department of Labor and Industry
IHS - IHS Global Insight
BOI - Board of Investments
LFD - Legislative Fiscal Division
DOR - Montana Department of Revenue
SABHRS - Statewide Accounting, Budgeting, Human Resource System
Computed - Computed using collections and tax rate
DOT - Montana Department of Transportation

Attachment 2

Legislative Fiscal Division

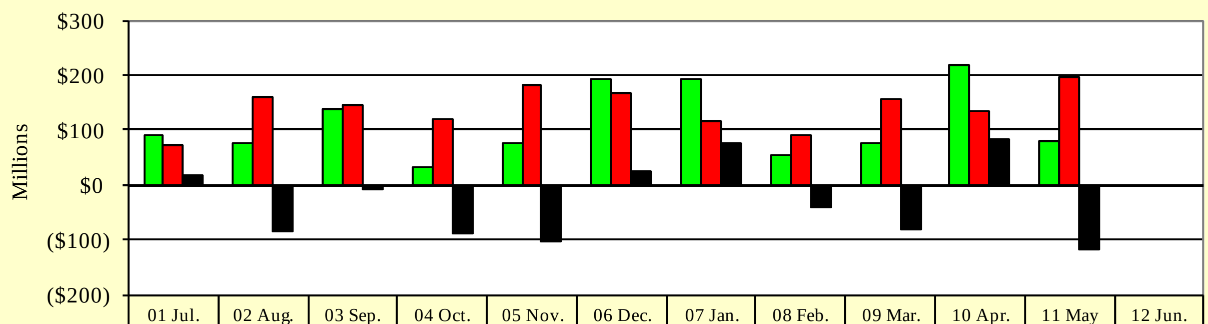
http://leg.mt.gov/css/fiscal

General Fund Cash Balance By Month - FY 2010

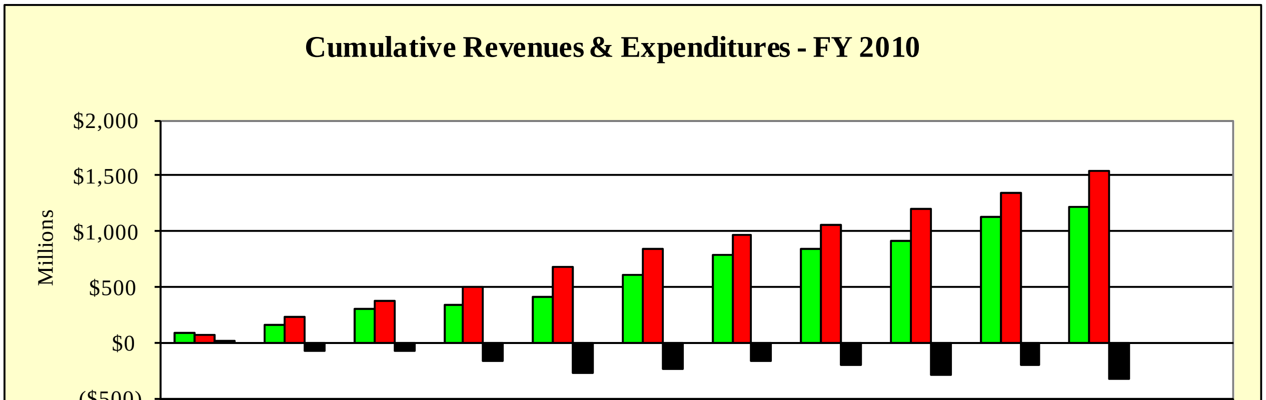
Period	Cash In Bank Monthly Change	Cash In Bank Cumulative	Cash Variations * Current Year Only
Beginning	446,407,475.56	446,407,475.56	
07/30/09	(6,614,483.38)	439,792,992.18	(6,614,483.38)
08/31/09	(74,152,696.93)	365,640,295.25	(80,767,180.31)
09/30/09	(41,150,783.45)	324,489,511.80	(121,917,963.76)
10/31/09	5,562,359.78	330,051,871.58	(116,355,603.98)
11/30/09	(92,094,829.66)	237,957,041.92	(208,450,433.64)
12/31/09	6,989,272.24	244,946,314.16	(201,461,161.40)
01/31/10	88,502,097.97	333,448,412.13	(112,959,063.43)
02/28/10	(54,953,076.58)	278,495,335.55	(167,912,140.01)
03/31/10	(68,328,633.38)	210,166,702.17	(236,240,773.39)
04/30/10	80,733,132.38	290,899,834.55	(155,507,641.01)
05/31/10	(120,528,915.59)	170,370,918.96	(276,036,556.60)
06/08/10	(3,726,834.74)	166,644,084.22	(279,763,391.34)

* Cash variation represents the net change in cash for the year without including the carryover cash balance. As of the today, the state general fund has expended $279.8 million more than deposited as revenue.

Monthly Revenues & Expenditures - FY 2010



	01 Jul.	02 Aug.	03 Sep.	04 Oct.	05 Nov.	06 Dec.	07 Jan.	08 Feb.	09 Mar.	10 Apr.	11 May	12 Jun.
Revenues	89.380	74.356	136.613	31.025	77.329	192.109	191.058	52.402	74.254	217.936	80.867	-
Expenditures	72.846	160.913	144.967	119.055	180.509	165.881	114.728	91.714	155.573	135.481	197.289	-
Difference	16.534	(86.557)	(8.354)	(88.030)	(103.180)	26.228	76.330	(39.312)	(81.319)	82.455	(116.422)	-



	01 Jul.	02 Aug.	03 Sep.	04 Oct.	05 Nov.	06 Dec.	07 Jan.	08 Feb.	09 Mar.	10 Apr.	11 May	12 Jun.
Revenues	89.380	163.736	300.349	331.375	408.704	600.813	791.870	844.273	918.527	1,136.464	1,217.330	-
Expenditures	72.846	233.759	378.726	497.781	678.289	844.170	958.899	1,050.613	1,206.186	1,341.666	1,538.956	-
Difference	16.534	(70.023)	(78.377)	(166.406)	(269.585)	(243.357)	(167.029)	(206.340)	(287.659)	(205.202)	(321.626)	-

Attachment 3

U.S. Economy - Perspective Article

Published: Wed 09 Jun 2010

Fed Chairman Testifies to the U.S. House Budget Committee

Bernanke provides upbeat outlook for the U.S. economy and soothes jitters over the Eurozone fiscal crisis, but closes with a stern warning on nation's fiscal sustainability.

Chairman Ben Bernanke provided a relatively upbeat outlook for the U.S. economy that largely reflects the Federal Reserve's recently updated central tendency projections. The Fed is projecting that growth will remain solid, near 3.5%, in 2010 and then accelerate modestly in 2011. Core inflation is moderating, while overall inflation should remain subdued.

IHS Global Insight is forecasting real GDP growth of just under 3% in 2011, so the Fed's outlook does look a little optimistic from our perspective. Fiscal drag connected with higher federal taxes and lower federal spending in 2011 and beyond—and expectations thereof—will be a major hurdle to overcome for growth to pick up in 2011.

Reading between Bernanke's lines, it is clear that monetary policy will have to remain very accommodative for quite some time in this type of environment.

Bernanke touched on the European fiscal and currency crises, indicating that the Fed believes the policy mechanisms put in place, while tardy, should begin to restore confidence in the Eurozone's fiscal situation. Collateral damage to the U.S. economy should be limited, as there are major offsets in the form of lower interest rates and industrial commodity prices. On this subject, we would agree with the Fed chairman.

Finally, Bernanke issued a strongly issued warning on long-term U.S. fiscal sustainability. Even after economic and financial conditions return to normal, the federal budget is on an unsustainable path—the aging of the U.S. population will put severe strains on Social Security and healthcare spending.

The Fed chairman closed with a stern warning "unless we make a strong commitment to fiscal responsibility, in the longer run, we will have neither financial stability nor healthy economic growth."

Completing his logic, ultimately, "Pax Americana" is at serious risk from these fiscal imbalances.

by Brian Bethune