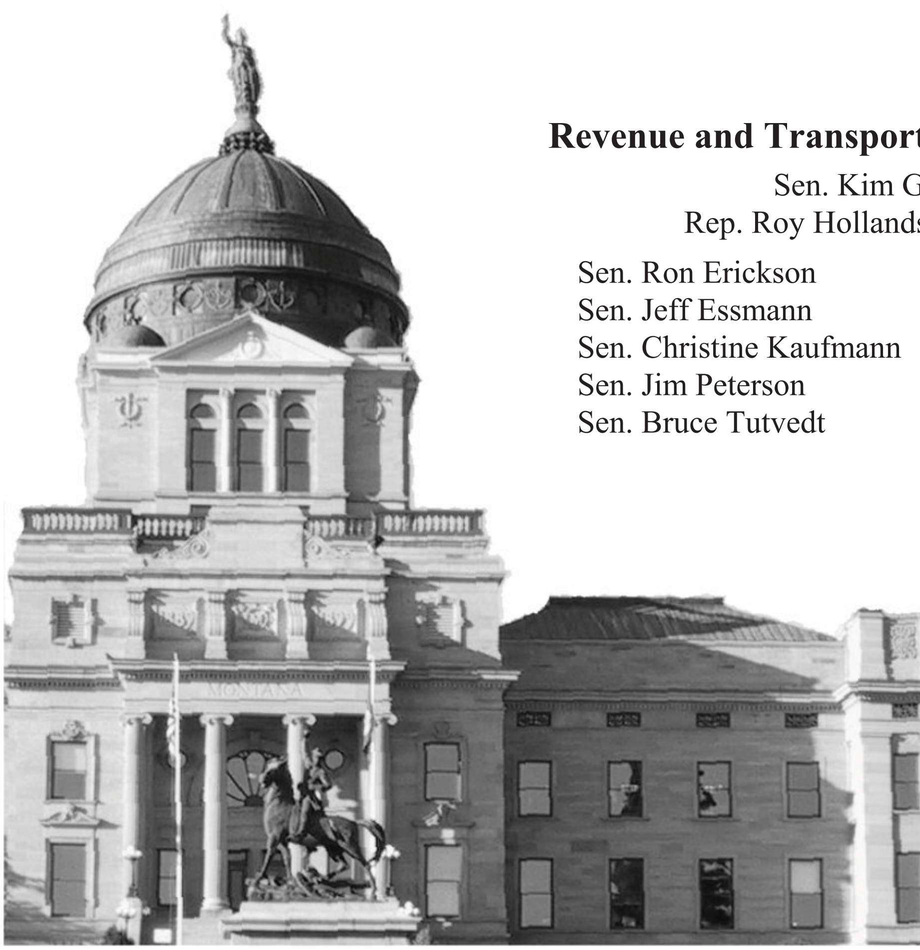
Legislative Budget Analysis

2013 Biennium

Volume 2 – Revenue Estimates

As Adopted by the Revenue and Transportation Interim Committee



Revenue and Transportation Interim Committee

Sen. Kim Gillan, Chairman
Rep. Roy Hollandsworth, Vice Chairman

Sen. Ron Erickson	Rep. Dick Barrett
Sen. Jeff Essmann	Rep. Cydnie Boland
Sen. Christine Kaufmann	Rep. Brian Hoven
Sen. Jim Peterson	Rep. Mike Jopek
Sen. Bruce Tutvedt	Rep. Bill Nooney

Legislative Fiscal Division
Revenue Staff

Terry Johnson

Catherine Duncan
Stephanie Morrison

Roger Lloyd
Jim Standaert
Brian Hannan

Legislative Fiscal Division

www.leg.mt.gov/css/fiscal

Revenue Estimates
Table of Contents

Revenue Estimates
Table of Contents (Continued)

Introduction

Purpose of the Volume

As delineated in Section 5-5-227(2)(a), MCA, the Revenue and Transportation Interim Committee (RTIC) is required to prepare "an estimate of the amount of revenue projected to be available for legislative appropriation." In addition, sections 5-12-302(2) and 5-12-302(6) specifically require the Legislative Fiscal Analyst (LFA) to "estimate revenue from existing and proposed taxes" and also requires the LFA to "assist the revenue and transportation interim committee in performing its revenue estimating duties."

The purpose of this volume is to document the LFD recommendations regarding anticipated revenues for FY 2011 through 2013. It should be noted that the accompanying LFD estimates are based on current federal and state laws and do not include estimates for revenues due to litigation or any other pending legal issues. This position is consistent with past recommendations to the RTIC.

Montana Economic Outlook

Montana state government, like any other business, is influenced by economic and demographic developments. For example, Montana's economic base and the strength of the U.S. economy determines the level of revenues collected from personal and corporate income taxes, property taxes, natural resource taxes, and investment earnings. Similarly, both economic and demographic variables affect state government disbursements for education, human services, corrections, and other governmental services.

Montana's total revenue base is comprised of a number of taxes and fees plus numerous federal reimbursements or grants. Revenues are further enhanced from the investment of trust monies and idle cash pending disbursement from the state treasury. Since individual income tax is the state's largest general fund tax source, economic developments or trends in the areas of employment and income levels significantly influence available revenues to fund governmental services. Federal revenue correspondingly is used to fund a number of human service, transportation, and educational services. In a number of instances, general or state special revenue fund dollars are required to provide a state match before the federal funds can be disbursed.

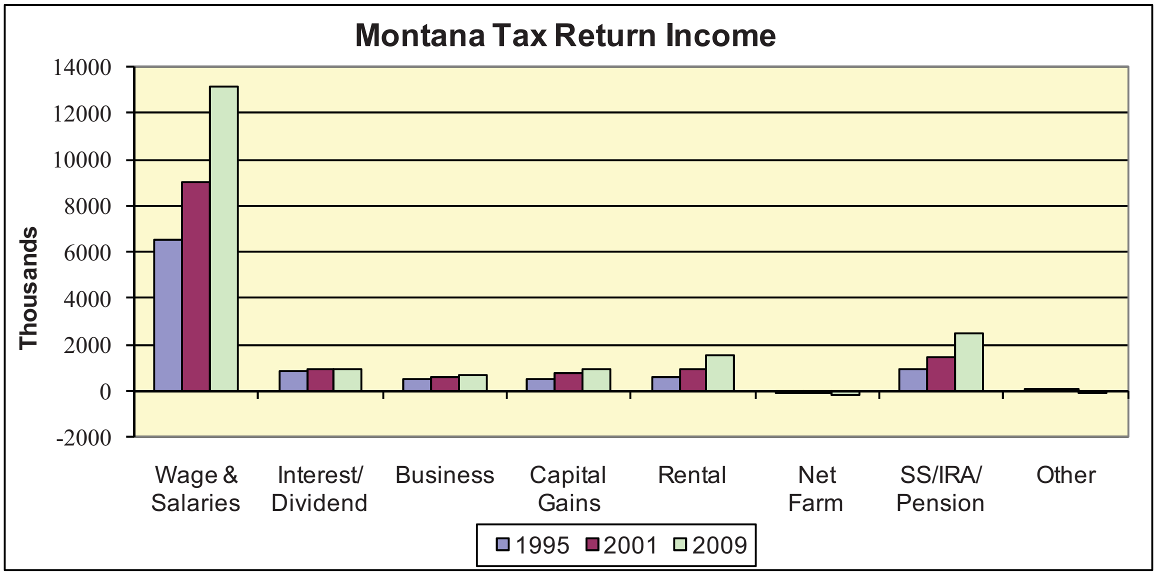
Montana's total expenditure base is targeted toward educational and human service programs with a significant allocation to highway construction. Education and human service costs are driven by some of the same economic and demographic conditions that influence state revenues. If employment levels increase, this usually translates to an increase in population or a reduction in unemployment levels. With population increases comes a corresponding increase in educational and human service costs. A greater population requires a better transportation system not only for the general populace, but also for the businesses that expect to expand to meet the needs of an ever-growing population.

Over the past 20 years, Montana has experienced a wide variety of economic conditions. The 1990's were generally good years for Montana's economy; with a few exceptions, Montana experienced above-average employment and wage levels that translated into strong tax revenue growth. This revenue growth was further enhanced by a significant increase in the equity markets and resulting growth in capital gains income. In 2001, the national economy went through a brief recession, which negatively impacted Montana's revenue stream by the same factors that had earlier created extraordinary growth. Beginning in FY 2004, general fund revenues began a period of unprecedented growth increasing by 9.4% annually from FY 2003 to FY 2008. At the beginning of FY 2008, the U.S. economy again slid into recession, led by the sub-prime mortgage crisis. Due to the high price of commodities, Montana's economy initially seemed unlikely to experience the same level of economic downturn; however, by FY 2009, it was apparent that general fund revenues were declining. Total general fund revenues declined 2.7% in FY 2009 and 10.0% in FY 2010.

The three income sources primarily responsible for Montana's revenue volatility are individual income tax, corporation income tax, and oil and natural gas production taxes. Individual income tax experienced increased growth from federal tax reform, and the housing and commodity bubbles; this led to increased in wage growth (especially in real wage growth per worker); higher rent, royalty, and partnership income; and higher capital gains income from 2004 through 2008. These increases in individual income tax revenues occurred even with the implementation of SB407, the state individual income tax reform legislation enacted by the 2003 Legislature. SB 407 reduced tax rates on income and instituted a new capital gains credit of 1% beginning January 1, 2005. The capital gains credit increased to 2% on January 1, 2007. Conversely, it was the decline of housing and commodity prices, as well as the drop in the stock market, that produced sharply lower revenues in FY 2009-2010. The corporation income tax revenues rebounded as Montana corporations have recovered from the recession of 2001 and the effects of September 11, 2001; the revenues retracted as Montana started to feel the effects of the more recent recession. Although the natural resource boom in Montana increased corporate profitability for energy companies and its residual industries, the declining level of production will continue to negatively impact the industry.

Key Risks to Economic Assumptions

Income – As the unemployment rate increases or stabilizes, Montana wage and salary income may decline or increase only modestly. Since the taxes paid on wage and salary income is the largest component of individual income tax revenue (Montana's largest general fund revenue source), even a minimal decline in wage and salary income could have a negative impact on general fund revenue. The graph below shows the importance of wage and salary income compared to the other components of income.

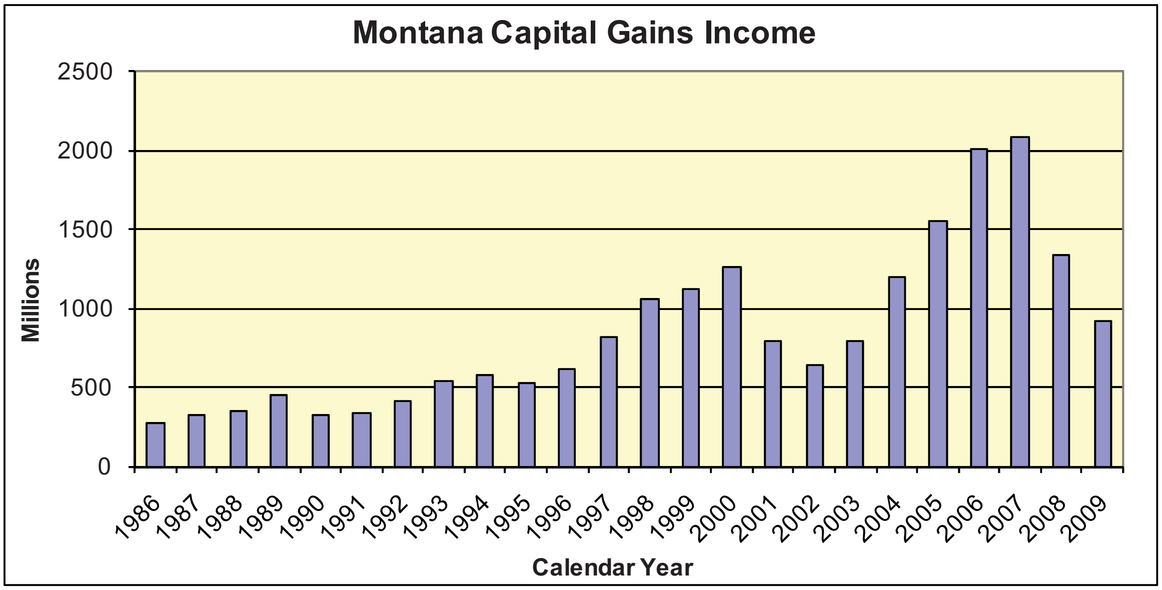


Interest Rates – The federal funds rate set by the Federal Reserve is currently at historical lows. This rate cannot get much lower and may increase if inflation shows signs of life. Low interest rates are a double-edged sword in which low rates may stimulate economic activity which potentially increases wage and salary and business income. On the other hand, Montana's earnings from trust funds and excess investable cash decrease fairly quickly at reduced interest rates. Investment income reported for income tax purposes also declines, although this impact can be delayed.

Corporate Profits - In light of the "Great Recession", a significant risk is the impact of the net operating loss (NOL) carry back provisions provided in 15-31-119, MCA. A NOL generally occurs when deductions exceed gross income. If for any taxable period a net operating loss is sustained, the loss must first be accounted for as a carry back to each of the three taxable periods proceeding the taxable period of the loss. If the NOL deductions cannot be fully deducted from the prior years, the remaining deductions may be carried forward to each of the five taxable periods following the taxable period of the loss. Typically, the NOL can be fully deducted through the three period carry back. The loss is deducted against taxes that have usually been paid prior to the period of the loss and refunds are issued for the paid taxes. This situation makes the impact of corporate NOL's on total fiscal year collections appear even greater than they may have been because much of the effect is realized in the current fiscal year.

Energy Prices – If the global economic recovery continues to be gradual, demand for energy commodities, primarily oil and natural gas, may be slow to recover. Conversely, if a "double dip" recession occurs reduced prices could prevail until a more vibrant economic recovery occurs. Low energy prices could hamper further exploration and development efforts.

Equities – The equity markets can play havoc on state general fund revenues. A significant portion of non-labor income is derived from net capital gains and interest and dividend income. Just because the equity markets are increasing does not necessarily mean state revenue will corresponding increase. In order for a gain to materialize, investors need to sell equities at a higher price than they paid for them. Conversely, investors may sell equities at a loss thereby offsetting other types of income. Losses can be carried forward at $3000 per year until the loss is liquidated. The figure below shows the history of capital gains income since 1986.



Federal Tax Policy –

Federal tax policy could impact state general fund revenues either positively or negatively. At this time, Congress has adjourned until November 15 without taking any action on the Economic Growth and Tax Relief Reconciliation Act of 2001, and the Jobs Growth Tax Relief and Reconciliation Act of 2003 tax reductions. Without Congressional action, these reductions will expire on January 1, 2011. No action could translate to higher tax revenues in FY 2011, 2012 and 2013. Current general fund estimates are based on a two-year continuation of the tax reductions. The table below shows the impact on state general fund revenues if the reductions are not extended.

Repeal of Federal Tax Reductions

Estimated Impact in Millions

Revenue Category	Estimated FY 2011	Estimated FY 2012	Estimated FY 2013	3 Year Total
Individual Income Tax	(0.118)	(0.254)	(0.155)	(0.527)
Estate Tax	1.530	7.669	12.356	21.555
Totals	**$1.412**	**$7.415**	**$12.201**	**$21.028**

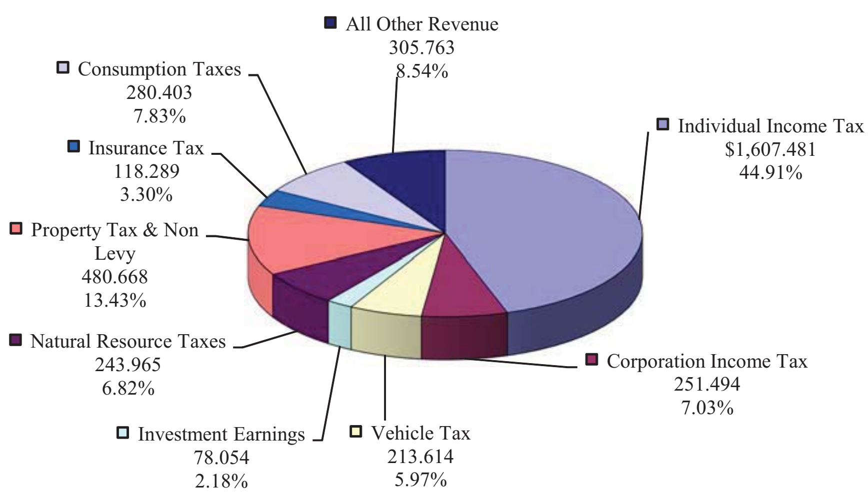
Major revenue source contributors to the state general fund (and interrelated state special funds) are experiencing deep declines from FY 2008 levels. These declines continued through FY 2010 and are anticipated to continue below the FY 2008 level until the end of the 2013 biennium. A slow gradual economic recovery should improve state general fund revenues, but at a slow pace. Such unprecedented turmoil also complicates the accurate prediction of future revenues and, hence, complicates the budgeting process for the legislature.

General Fund Revenue Implications

Montana's fiscal outlook for revenue growth is less optimistic than the last biennium. The key economic assumptions targeted as most affecting state government receipts are Montana total income, employment, population levels, inflation rates, corporate profits, property values, interest rates, and energy prices.

As shown in the following figure, individual income tax, corporation income tax, property tax, vehicle tax, and natural resource taxes are expected to contribute 78% to the total general fund revenue stream during the 2013 biennium. Total general fund revenues for the 2013 biennium are projected to increase 8.5% over the 2011 biennium projections. The comparative change by major revenue category is shown at the bottom of the figure.

General Fund Revenue
By Major Component 2013 Biennium



Major Category	2011 Biennium Estimate Millions	2013 Biennium Estimate Millions	Percent Change	Percent of 2013 Biennium
Individual Income Tax	$1,456.595	$1,607.481	10.36%	44.91%
Corporation Income Tax	191.221	251.494	31.52%	7.03%
Vehicle Tax	210.887	213.614	1.29%	5.97%
Investment Earnings	57.784	78.054	35.08%	2.18%
Natural Resource Taxes	235.104	243.965	3.77%	6.82%
Property Tax & Non Levy	451.594	480.668	6.44%	13.43%
Insurance Tax	109.480	118.289	8.05%	3.30%
Consumption Taxes	265.401	280.403	5.65%	7.83%
All Other Revenue	321.211	305.763	-4.81%	8.54%
Total General Fund	**$3,299.277**	**$3,579.731**	**8.50%**	

The next section of the report highlights the significant economic assumptions used by the LFD to develop the revenue estimate recommendations contained in this document. Each assumption is discussed and is graphically portrayed to give the reader a perspective of the historical trend versus the forecast amount.

Legislative Fiscal Division
General Fund Revenue Estimates
In Millions

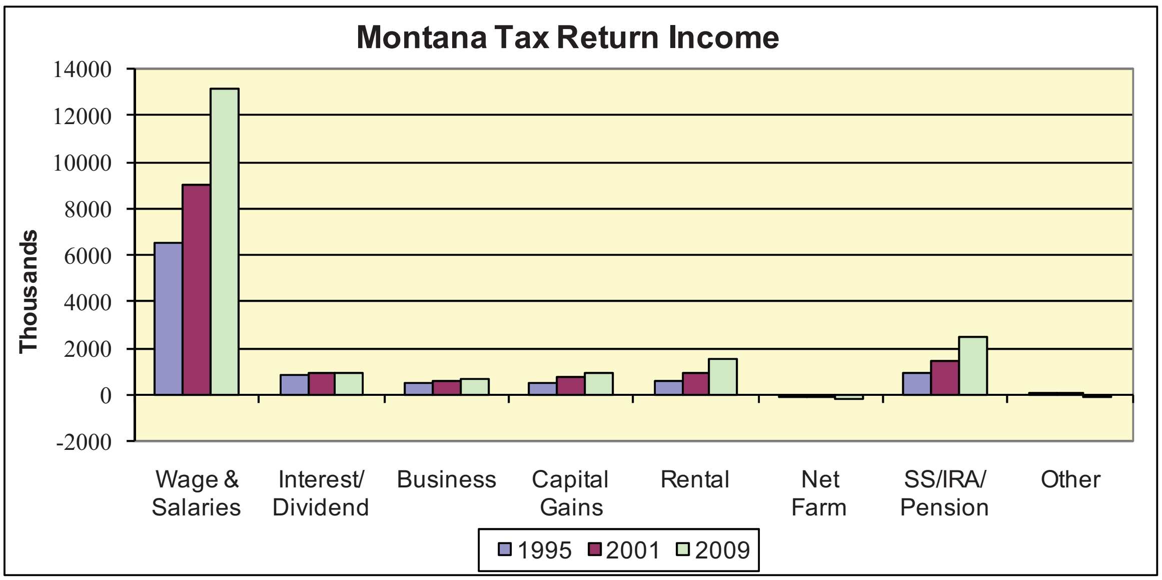
	Source of Revenue	Percent of 2010	Actual Fiscal 2010	Estimated Fiscal 2011	Estimated Fiscal 2012	Estimated Fiscal 2013	Estimated Fiscal 10-11	Estimated Fiscal 12-13	Cumulative % of Total
1	Individual Income Tax	44.12%	$717.834	$738.761	$781.891	$825.590	$1,456.595	$1,607.481	44.91%
2	Property Tax	13.67%	222.510	229.084	237.809	242.859	451.594	480.668	58.33%
3	Corporation Income Tax	5.40%	87.901	103.320	123.315	128.179	191.221	251.494	65.36%
4	Vehicle Tax	5.50%	89.485	92.210	91.857	92.188	181.695	184.045	70.50%
5	Common School Interest and Income	0.00%	-	-	-	-	-	-	70.50%
6	Insurance Tax & License Fees	3.37%	54.892	54.587	57.500	60.789	109.480	118.289	73.80%
7	Coal Trust Interest	1.65%	26.914	26.512	27.065	27.418	53.426	54.483	75.33%
8	US Mineral Royalty	1.86%	30.288	29.674	29.714	28.876	59.962	58.590	76.96%
9	All Other Revenue	2.17%	35.360	28.883	27.394	28.077	64.243	55.471	78.51%
10	Tobacco Settlement	0.21%	3.469	3.565	3.564	3.559	7.034	7.123	78.71%
11	Telecommunications Excise Tax	1.45%	23.523	21.772	21.759	21.887	45.295	43.646	79.93%
12	Video Gambling Tax	3.22%	52.396	55.340	57.562	60.199	107.736	117.761	83.22%
13	Treasury Cash Account Interest	0.17%	2.692	1.666	6.173	17.398	4.358	23.571	83.88%
14	Estate Tax	0.01%	0.091	0.005	-	-	0.096	-	83.88%
15	Oil & Natural Gas Production Tax	5.87%	95.491	101.421	101.803	100.119	196.912	201.923	89.52%
16	Motor Vehicle Fee	0.88%	14.377	14.815	14.758	14.811	29.192	29.569	90.35%
17	Public Institution Reimbursements	1.35%	22.000	17.555	17.172	17.374	39.555	34.546	91.31%
18	Lodging Facility Use Tax	0.76%	12.331	12.852	13.515	14.014	25.183	27.529	92.08%
19	Coal Severance Tax	0.63%	10.322	14.848	13.300	13.552	25.170	26.852	92.83%
20	Liquor Excise & License Tax	0.96%	15.626	16.104	16.778	17.487	31.730	34.265	93.79%
21	Cigarette Tax	1.98%	32.218	31.029	30.883	29.913	63.247	60.796	95.48%
22	Investment License Fee	0.38%	6.225	6.008	6.496	6.740	12.233	13.236	95.85%
23	Lottery Profits	0.65%	10.631	12.327	11.916	12.640	22.958	24.556	96.54%
24	Liquor Profits	0.55%	9.000	9.511	9.727	10.008	18.511	19.735	97.09%
25	Nursing Facilities Fee	0.33%	5.300	5.039	4.929	4.820	10.339	9.749	97.36%
26	Foreign Capital Depository Tax	0.00%	-	-	-	-	-	-	97.36%
27	Electrical Energy Tax	0.29%	4.713	4.452	4.480	4.535	9.165	9.015	97.62%
28	Metalliferous Mines Tax	0.40%	6.541	6.481	7.437	7.753	13.022	15.190	98.04%
29	Highway Patrol Fines	0.29%	4.646	4.666	4.685	4.704	9.312	9.389	98.30%
30	Public Contractors Tax	0.43%	6.969	6.477	5.716	5.705	13.446	11.421	98.62%
31	Wholesale Energy Tax	0.22%	3.556	3.657	3.738	3.818	7.213	7.556	98.83%
32	Tobacco Tax	0.33%	5.334	5.680	6.018	6.380	11.014	12.398	99.18%
33	Driver's License Fee	0.26%	4.156	3.561	4.166	3.612	7.717	7.778	99.40%
34	Rental Car Sales Tax	0.17%	2.807	2.999	3.175	3.288	5.806	6.463	99.58%
35	Railroad Car Tax	0.16%	2.579	2.031	2.096	2.155	4.610	4.251	99.70%
36	Wine Tax	0.12%	1.933	2.098	2.191	2.286	4.031	4.477	99.82%
37	Beer Tax	0.19%	3.032	3.142	3.185	3.230	6.174	6.415	100.00%
38	Telephone License Tax	0.00%	-	-	-	-	-	-	100.00%
39	Long Range Bond Excess	0.00%	-	-	-	-	-	-	100.00%
	Total General Fund	100.00%	$1,627.145	$1,672.133	$1,753.767	$1,825.963	$3,299.277	$3,579.731	100.00%

Significant Economic Assumptions

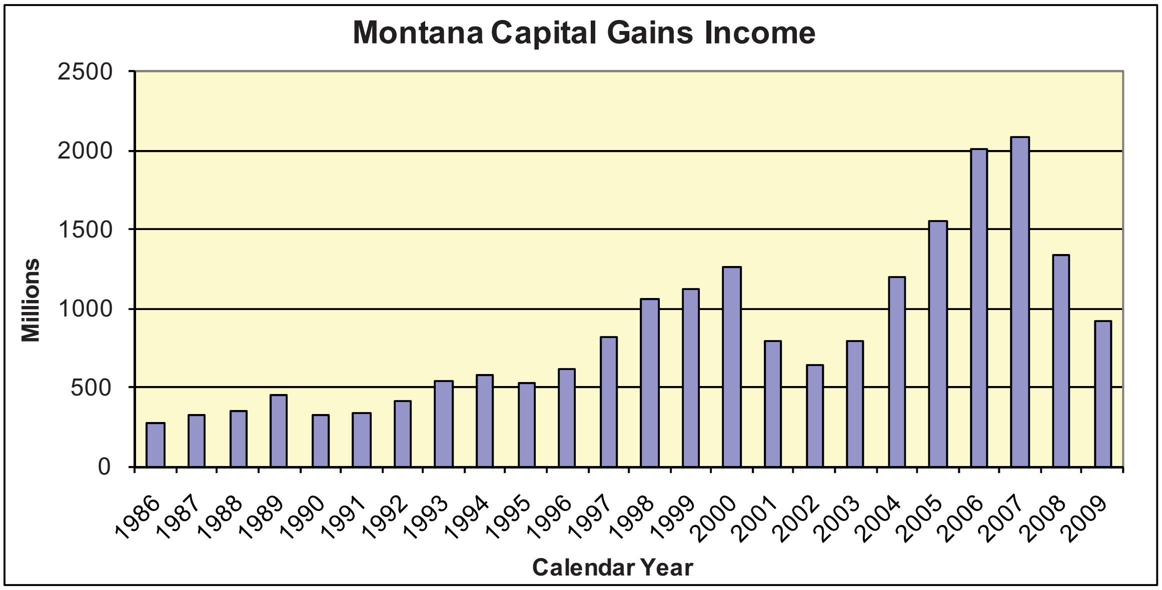
This section of the report highlights the significant economic assumptions used by the RTIC to develop the revenue estimate recommendations contained in this document. Each assumption is discussed and is graphically portrayed to give the reader a perspective of the historical trend versus the forecast amount.

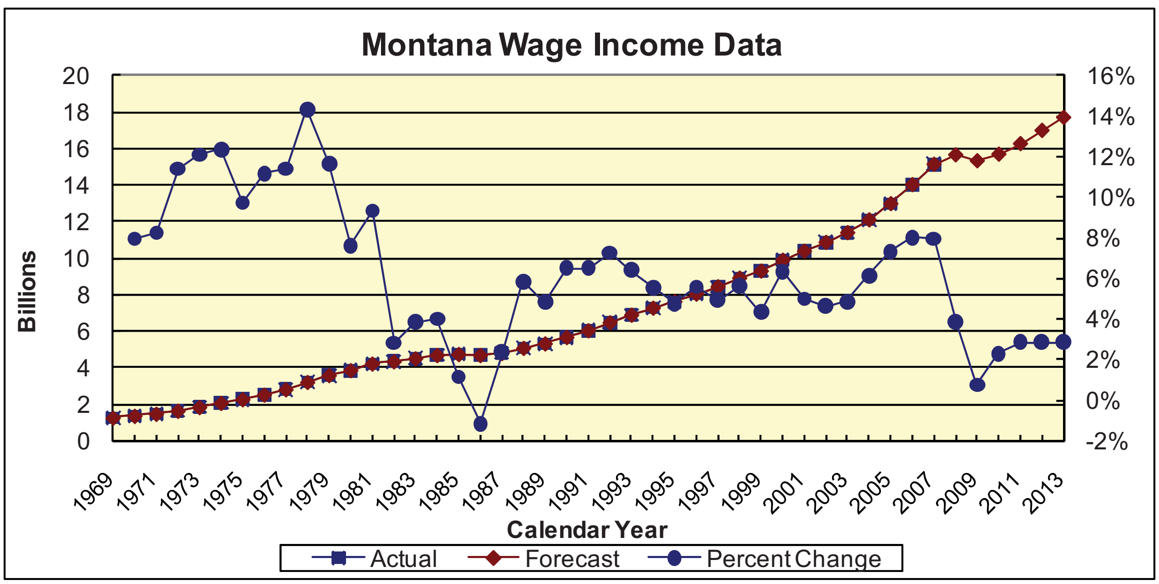
Montana Total Income

The total of all income sources listed on the Montana personal income tax form is referred to as Montana total income. The Department of Revenue tracks income from 11 different components, including wages, interest, dividends, business, capital gains, supplemental, rental, farm, social security, IRA and pension, and other incomes. Montana total income is the single most important variable to consider in the revenue estimation process. Of the 11 income items, wage and salary income provides the largest portion of Montana total income. Since 1990, wage and salary income has contributed an annual average of 65.1% of total income. In 2009, it contributed 67.3%, or $13.1 billion. The average compounded growth from 1990 to 2009 has been 5.2%.



In recent times, capital gains income has been the focus of much conversation and speculation. Capital gains income has increased in relative importance over the decade. In 1990, capital gains made up only 4.2% of total income, with reported income of $318 million. Capital gains income grew moderately through the decade, when in 2001 a significant decline occurred, coinciding with the recession. Rapid growth followed in the later part of the 2000 decade, and by 2007 capital gains had grown to 9.7% of total income, with income at $2,088.6 million. However, in 2008 capital gains income was again influenced by a recession and declined by over 35%. In 2009, capital gains income declined by almost 32% reaching the amount of $912 million. Projections of IHS indicate that capital gains income will increase by 26% annually between 2010 and 2013.





Montana Wages

The average annual growth in Montana Wages and Salaries has been 5.4% between 1990 and 2009. Wage growth exceeding this average occurred in the early nineties and again in 2004-2007. In both these periods inflation was relatively high, i.e. greater than 2.5%, and employment growth was relatively high. However, the growth of wages has declined sharply to rates of 3.9% and 0.75% in 2008 and 2009 respectively.

The following table displays the data considered in developing the forecast for the individual income tax. The Montana inflation forecast for 2010 through 2013, as provided by IHS in the October 2010 issue of forecasts, shows the rate of inflation remaining relatively low through the period of analysis. The state rate is expected to be 1.7% in 2011, 1.9% in 2012, and 2.0% in 2013.

The growth in wages between 2010 though 2013 is provided through the LFD wage and salary projections. From 2005 through 2007, wages on average grew at a rate of 7.6%. However in 2008 and 2009, wages grew at a rate of only 5.4% and -1.6% respectively. The state wages are expected to assume a slower rate of growth in the forecast period with growth of 3.6% in 2011, 4.3% in 2012, and 4.1% in 2013.

Employment is also expected to slow down in 2010 through 2013. Employment growth between 2003 and 2007 averaged 2.4%. However since the beginning of the recession in 2008, employment has slowed dramatically. In 2008 employment grew at only 0.2% and in 2009 Montana's employment growth turned negative. Future estimates for 2010 through 2013 project average growth of 0.8% annually.

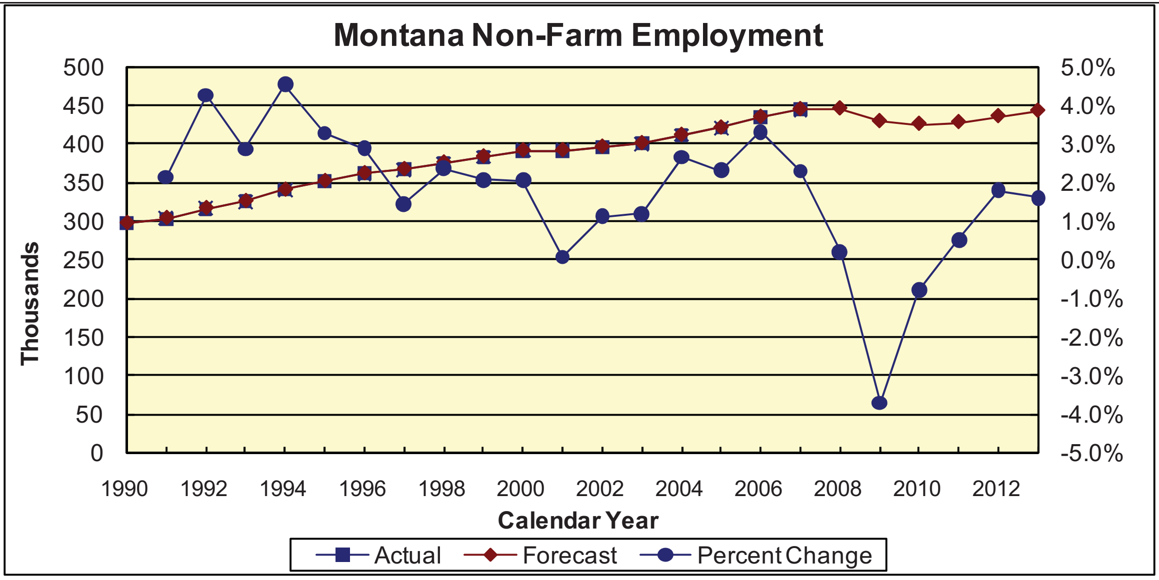
Growth in real wages per worker is defined as wages per worker adjusted for inflation, was low in the early nineties but has been above the 1991-2007 average of 0.6% growth since 1997. Considering the assumptions on growth in wages, employment, and inflation, real wages are expected to increase at a slow rate through the forecast period.

Wage and Salary Income Growth

	Calendar Year	Employment Growth	State Inflation	Real Wage Per Worker	Wage Growth
A	1991	2.1%	4.7%	-0.5%	6.4%
A	1992	4.3%	3.1%	-0.2%	7.3%
A	1993	2.9%	3.0%	0.5%	6.5%
A	1994	4.5%	2.5%	-1.4%	5.5%
A	1995	3.1%	3.0%	-1.3%	4.8%
A	1996	2.8%	2.8%	0.0%	5.6%
A	1997	1.3%	2.3%	1.2%	4.8%
A	1998	2.2%	1.7%	1.7%	5.7%
A	1999	2.0%	2.0%	0.5%	4.5%
A	2000	1.9%	3.7%	0.5%	6.3%
A	2001	1.2%	3.2%	0.5%	5.0%
A	2002	1.1%	1.1%	2.4%	4.7%
A	2003	1.2%	2.1%	1.6%	5.0%
A	2004	2.7%	3.3%	0.1%	6.1%
A	2005	2.2%	2.5%	2.4%	7.3%
A	2006	3.4%	4.3%	0.0%	7.9%
A	2007	2.3%	2.7%	2.4%	7.6%
A	2008	0.2%	5.0%	0.1%	5.4%
A	2009	-3.7%	-1.4%	3.7%	-1.6%
F	2010	-0.8%	1.1%	2.0%	2.3%
F	2011	0.5%	1.7%	1.3%	3.6%
F	2012	1.8%	1.9%	0.6%	4.3%
F	2013	1.6%	2.0%	0.5%	4.1%

Montana Employment

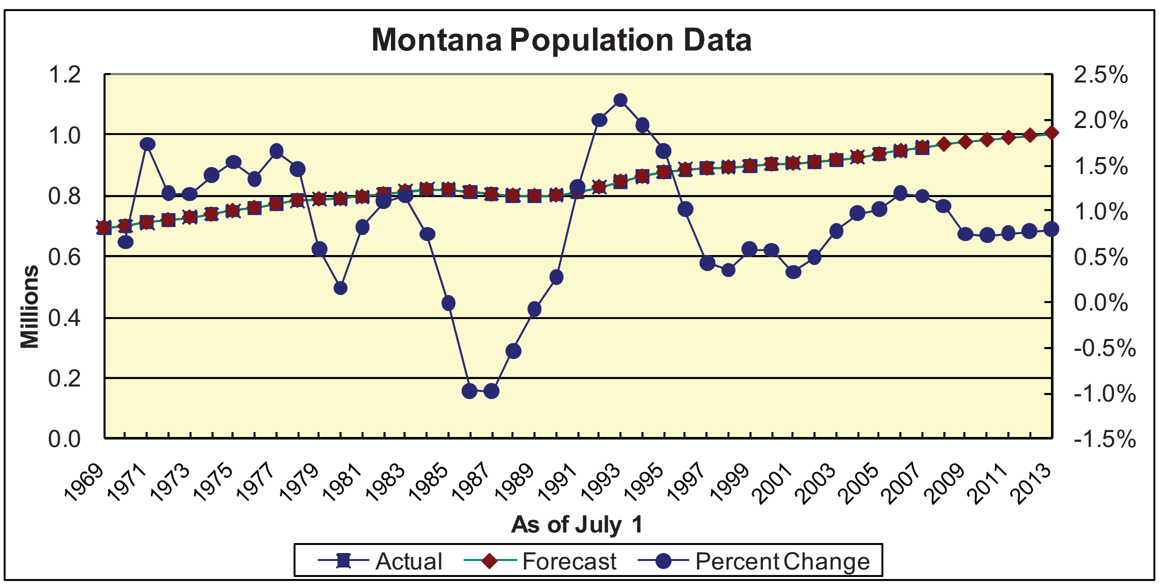
Average annual growth in total employment between 1990 and 2009 has been 1.2%. It is expected that employment growth through 2010 will be -0.8% and grow by about 0.5% in 2010. In 2009, the fastest growing sector in terms of employment has been health and education sector, which experienced a 2.0% annual increase in employment. At the same time, all other employment sectors except the government sector experienced negative growth. Experiencing the greatest drop, the construction sector lost 19% of the sector employment and future negative growth of 0.5% per year is projected between 2010 and 2013. However, most sectors will see increasing employment with the business and professional sector expecting annual average growth of 2.5% between 2010 and 2013. Total non-farm employment is expected to increase by 0.5% in 2011, 1.8% in 2012, and 1.6% in 2013.



Montana Population

Population statistics are used to develop estimates for many of the revenue sources including beer, wine, liquor, and cigarette taxes. In addition to those sources where population has a direct effect, the size of the population indirectly affects the profitability of all businesses and the employment levels statewide. Accurate population estimates are especially important when determining the changes expected in overall and per capita income for the state.

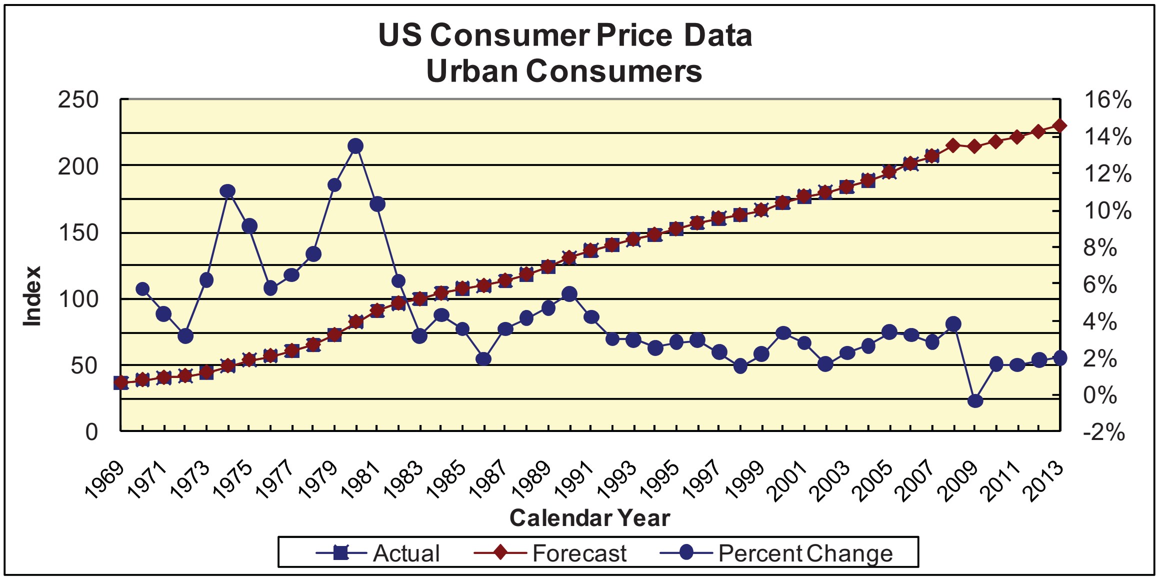
Historic population data is gathered from the U.S. Census department while projections are obtained from IHS. Since the early 1990’s, Montana has experienced positive growth in total population varying between 0.1% in 1998 to 2.3% in 1994. Growth in recent years has been slow, averaging 0.8% growth annually from 2007 to 2010. Growth through the next biennium is estimated at about 0.5% annually.



Inflation Rates

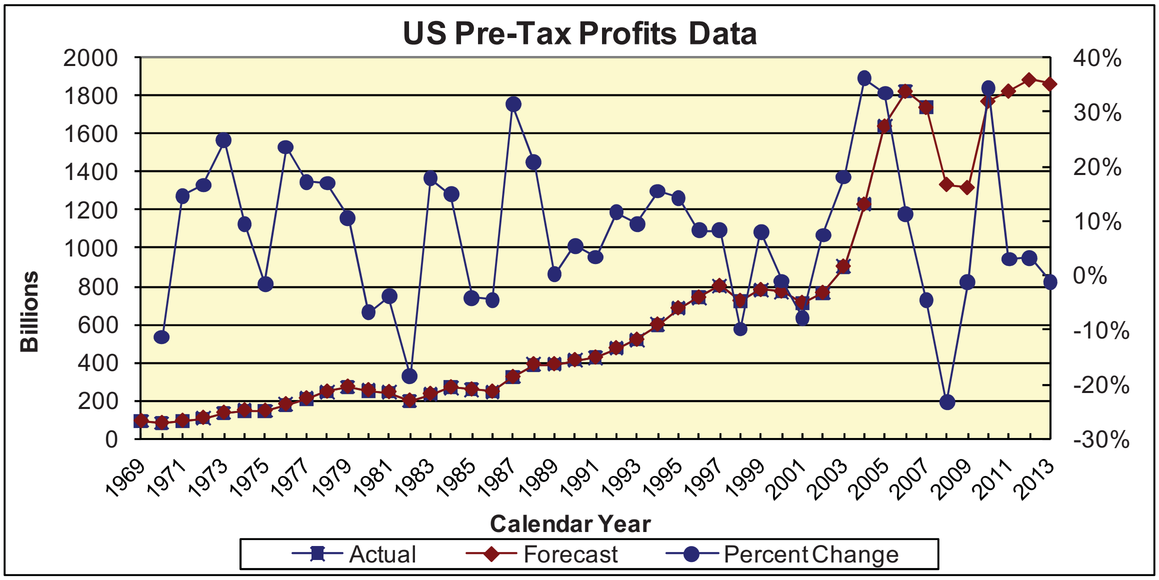
The inflation rate is measured by the price change of the Consumer Price Index (CPI) "shopping basket" of goods and services. Inflation is noted to have both good and bad effects. As prices rise, businesses increase prices and tend to become more profitable. At the same time, the consumer realizes a reduction in disposable income and spends less. Several areas where this information is vital in determining costs include minerals, timber, energy resources, and most services.

Since Montana's individual income tax structure is fully indexed by changes in the consumer price index, this assumption is critical in the formulation of the individual income tax forecasts. The U.S. Bureau of Labor Statistics provides the historical CPI data for the all-urban customers data set. Since 1990, the average annual rate of inflation has been 2.8%. IHS forecasts inflation at 1.6% for 2010 and 2011, 1.9% for 2012, and 2.0% in 2013.



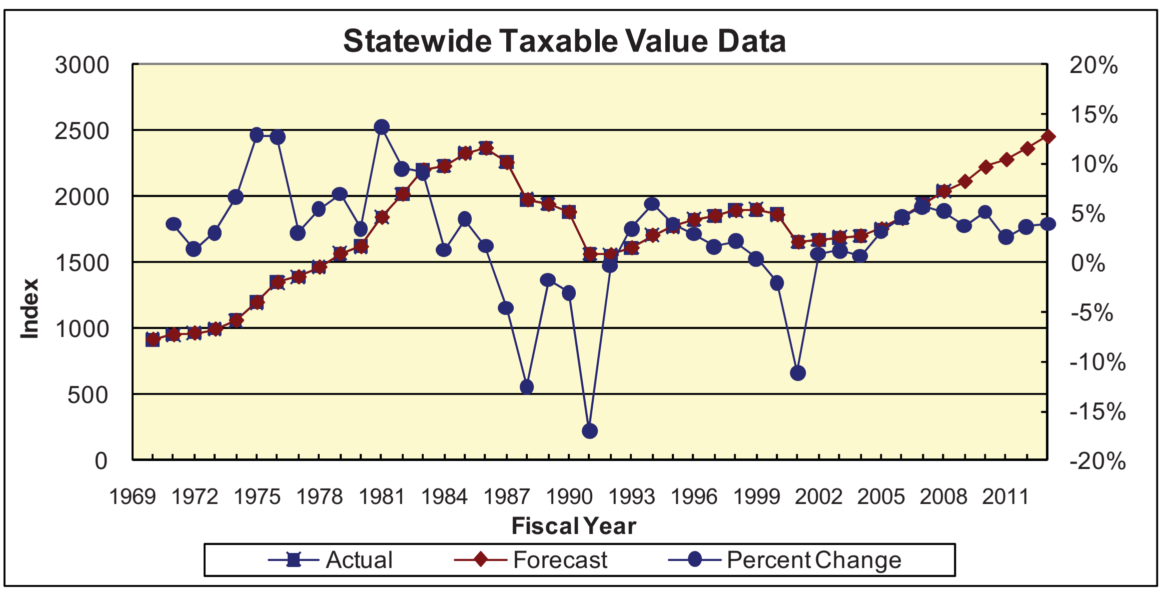
Corporate Profits

The profitability of corporate America is an important factor in estimating revenues. Corporate profitability affects both corporation license tax and individual income tax estimates. When corporations are profitable nationally, there is an expectation that corporations will be profitable in Montana. Additionally, greater corporate profitability is largely responsible for the amount of dividends corporations pay to stockholders as well as the value of equity investments. During the most recent years, the reduction of corporate profits has translated to lower corporate license tax collections. According to IHS, between 1990 and 1997, US corporation pre-tax profits increased by an annual average of 10.3%. However, from 1997 through 2001, profits decreased by an average of 3.0%, the greatest decrease of 8.5% occurring in 2001. Between 2006 and 2010, corporate profitability decreased at an average annual rate of 0.7%. During the forecast period, corporation profits are expected to grow at a rate of 0.7% annually.



Property Values

Change in statewide property values is the critical assumption behind the estimates for property taxes. Historic property values are obtained from the Montana Department of Revenue. Total statewide taxable value increased slowly during the first part of the 1990's, but fell in FY 2000. This decline was primarily due to business equipment tax changes enacted by previous legislatures. Other reductions occurred in electrical generating and telecommunication property. Property values resumed an upward trend in 2001 and have increased every year since that time. On January 1, 2009, new reappraisal values were placed on residential, commercial, agricultural land and timber land. The 2009 legislature mitigated these increases by continuing to phase in assessed values and providing a schedule over the following six years by which tax rates are decreased and homestead and comstead exemptions are increased. Taxable values are expected to increase at an annual average of 3.3% between FY 2010 and FY 2013, compared with 4.5% per year between FY 2004 through FY 2010.



Significant changes have taken place in statewide property values since FY 1998. In that year, 48.0% of total statewide value was in class 4, residential and commercial property, and 11.5% of total value was in class 8, business equipment personal property. In FY 2010, the class 4 taxable value was 60.0% of the total property tax base, while class 8 was only 7.8% of the base.