

Perspectives on the Economy and Demographics



SUMMARY

The general outlook for the US and Montana's economy for the next 3 years is bleak. Montana's economy is affected by prices for oil and natural gas, coal and metals. To a large extent though, Montana's economy and state revenues are also affected by national conditions beyond our control. Interest rates, global commodity demand, capital gains, and profits of national corporations are major drivers that determine a large portion of the state's general fund revenues. These and many other, economic indicators are used to forecast revenue for the fiscal period 2009 – 2011. Revenues are forecast to decline from FY 2008 levels in fiscal years 2009 and 2010, but show signs of recovery in FY 2011. If the recession deepens and lengthens, the revenue outlook may even be worse. These economic indicators change as rapidly as the economic climate worldwide. In November, the Revenue and Transportation Interim Committee (RTIC) adopted the Legislative Fiscal Division's (LFD) economic assumptions (except property tax reappraisal) and accompanying revenue estimates. Since that time, economic conditions have deteriorated further and the LFD revenue staff has update the revenues estimate based on changes to key economic indicators. These are indicators are: long and short-term interest rates, wages and salaries, commodity prices, and corporate profits. The following is a summary of these and other assumptions as revised by the LFD.

MAJOR ECONOMIC ASSUMPTIONS USED BY RTIC/LFD

As delineated in Section 5-5-227(2)(a), MCA, the RTIC is required to prepare “an estimate of the amount of revenue projected to be available for legislative appropriation.” The estimate and underlying assumptions are intended to be used in any estimation of revenue, including the preparation of fiscal notes. By statute, the LFD assists the revenue and transportation interim committee in performing its revenue estimating duties by submitting its recommendations and assumptions. The Office of Budget and Program Planning also presents the executive’s revenue estimates. Although little collaboration took place between the two offices, the three-year general fund revenue estimates were within \$1.1 million of each other. However, individual revenue sources, assumptions, and methodologies varied substantially. The RTIC accepted the LFD’s estimates, but modified the property tax estimates to exclude the effects of property reappraisal. These official estimates and assumptions are contained in HJ 2, the revenue estimate resolution. Since then, economic events have worsened and both the executive and the LFD have revised their revenue estimates based on the rapidly deteriorating economic conditions.

The LFD revenue staff has changed applicable economic assumptions to reflect the most current data available and recommends the legislature adopt these changes and the resulting estimates of revenue. Following are the major economic assumptions used by the RTIC as modified for the LFD changes, as well as the general economic outlook for the 2011 biennium.

ECONOMIC INDICATORS

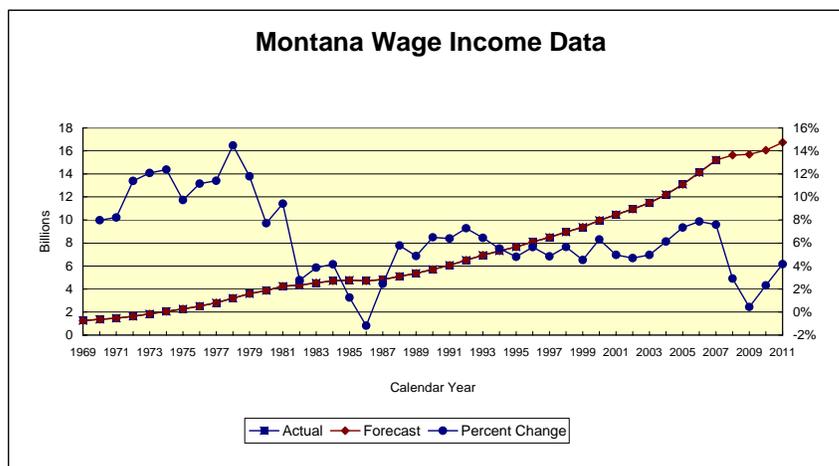
The four major economic assumptions the RTIC used to forecast the state’s general fund revenue for FY 2009 – FY 2011 are discussed in detail below. These four are: income, interest rates, corporation indicators, and energy prices.

Income

Montana’s income, as measured by gross state product (GSP), is estimated to be \$1,588 million in 2008. GSP is projected to grow by 1.8 percent, in real terms, between 2008 and 2011. This rate of growth, as obtained from the most recent Global Insight projections, exceeds expectations for the growth of the gross national product, projected to be 0.9 percent over the same period. Service industries, including professional, business, educational, health, and financial services, are the principal source of income to Montana and currently account for 41 percent of GSP. Since 2000, service sectors have grown in relative importance, from 39 percent of GSP in 2000, and are expected to remain constant in the upcoming biennium, growing only as fast as the Montana economy as a whole. Other industrial groups important to the state’s overall income are agriculture, mining, and construction, 12 percent GSP, and governmental activities, 15 percent GSP.

Income as related to state taxes is primarily driven by wages and salaries. The average annual growth in Montana wages and salaries has been 5.9 percent between 1991 and 2007. Wage growth exceeding this average occurred in the early nineties and again in the last four years, 2004-2007. In both these periods inflation was relatively high, i.e. greater than 2.5 percent, and employment growth was relatively high.

Figure 1



With the recent news of an economic recession and in response to rapidly changing economic conditions, the LFD has revised the expectation for wage and salary growth over the 2011 biennium. Because IHS Global Insight has not released a revised Montana-specific forecast, the growth in wages for calendar 2008 through 2011 is calculated as a ratio to the most recent forecasts of national wage growth. As shown in Figure 1, wage growth of only 2.9 percent is expected in calendar 2008, dropping to 0.4 percent in 2009, and rising somewhat to 2.3 percent in 2010 and 4.2 percent in 2011.

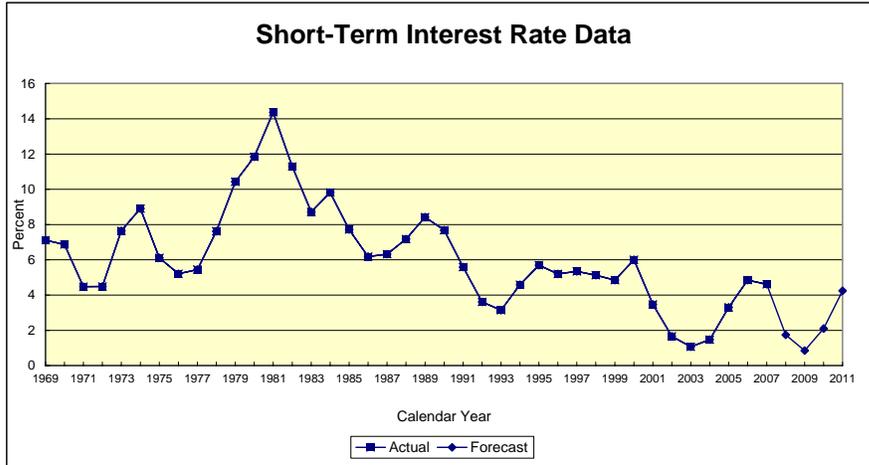
Interest Rates

Interest rates have been highly volatile over the past few years. To a large degree, interest rates are controlled by the Federal Open Market Committee (FOMC). The FOMC can control interest rates by targeting the federal funds rate (the rate banks charge each other for short term loans to meet reserve requirements) for increases or decreases. With the events of September 11, 2001 and the recession that followed, FOMC reduced interest rates. In 2004, with fears of inflation, the FOMC reversed course, causing interest rates to rise. In 2007 and to date, working under the threat of recession, the FOMC started reducing interest rates in hopes of spurring economic growth and providing liquidity to the stalled financial sector.

A large portion of Montana’s revenues is derived from investment earnings from trust accounts and daily invested cash. Interest rates also affect the amount of investment income that is reported on individual income tax returns. As such, interest rates are a significant assumption when estimating future state revenues, and are fundamental in understanding the climate in which consumers and businesses are likely

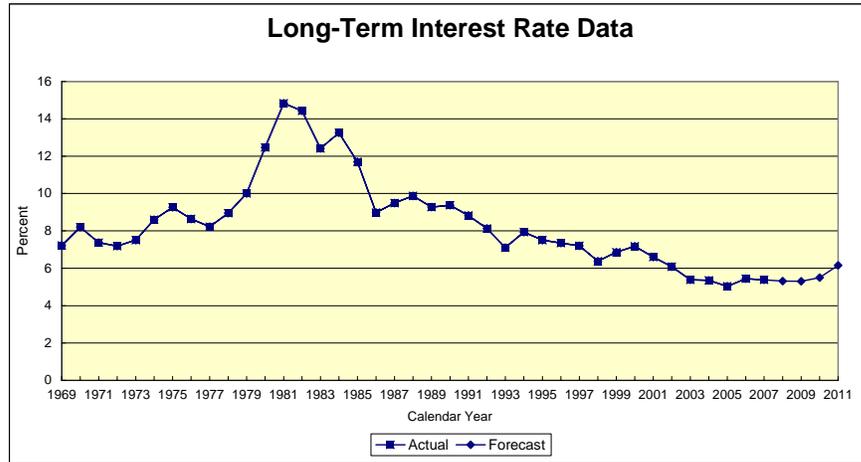
to make investments and large purchases. While low interest rates produce less revenue for Montana’s trust and interest holdings, higher income tax earnings might be expected as construction and sales activities increase.

Figure 2



Two types of interest rates, long and short-term, are estimated and used in determining future revenues. Both rates are an average across a selection of investment instruments. The forecast rates are obtained from HIS Global Insight. Due to the volatility of interest rates in the evolving recessionary economic climate, interest rate projections have been revised since the rates were approved by the RTIC. Now, HIS Global Insight projects short-term interest rates to decline sharply to about 0.8 percent and then rebound to 4.3 percent by FY 2011, as shown in Figure 2. Long-term rates are expected to remain stable through the 2011 biennium with a modest increase by FY 2011, as shown in Figure 3.

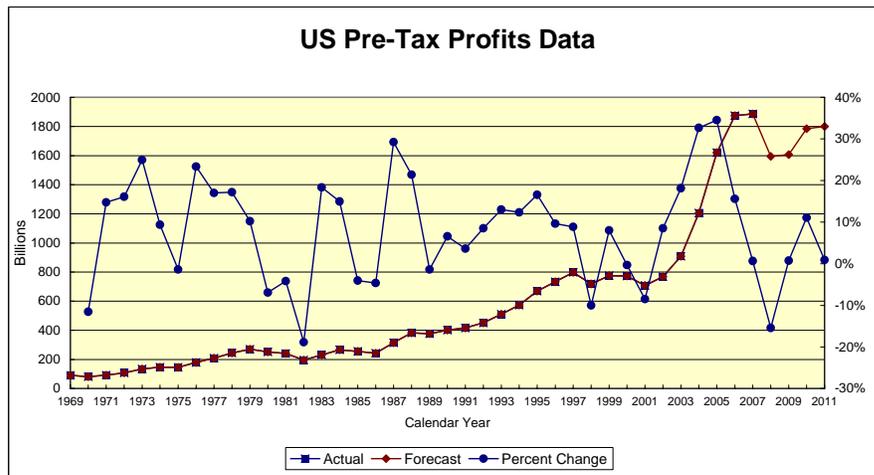
Figure 3



Corporation Indicators

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.

Figure 4



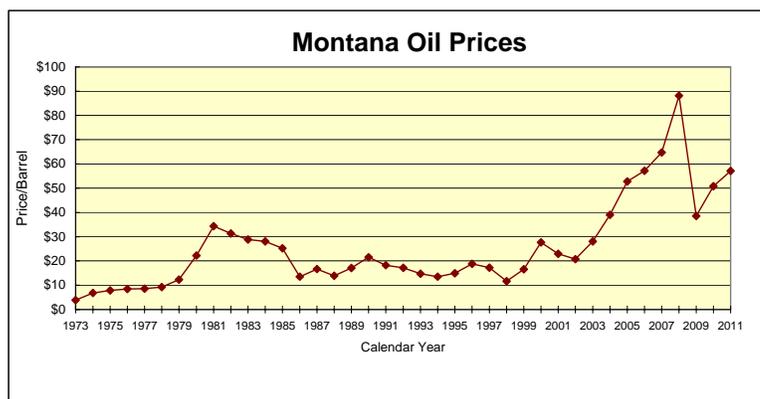
During the most recent years, the reduction of corporate profits has resulted in lower corporate license tax collections. According to IHS Global Insight, between 1990 and 1997, US corporation pre-tax profits increased by an annual average of 10.3 percent. However, from 1997 through 2001, profits decreased by an average of 3.0 percent, the greatest decrease of 8.5 percent occurring in 2001. In 2004 and 2005, corporate

profitability increased by 32.7 percent and 34.5 percent respectively. That trend is not expected to continue, and with the nation in recession, corporate profits are expected to decline substantially. In the most recent estimates provided by Global Insight Forecasting Service, profits are expected to decline by 7.4 percent in 2008 and 8.0 percent in 2009. As shown in Figure 4, corporate profits are expected to resume growth in 2010 and 2011, growing by approximately 5.8 each year.

Energy Prices

Energy prices have been volatile over the past decade. Changes in both supply and demand combine to cause dramatic price variations. For example, oil prices have varied between \$12.87 dollars per barrel in the fourth quarter of 1998 and 123.78 dollars per barrel in the fourth quarter of 2008. In 2008, oil prices soared as demand outstripped supply but as the world economy entered recession, prices began to decline. In recent months, the price of oil has made historic declines, and now has been reported to near \$30.00 dollars per barrel.

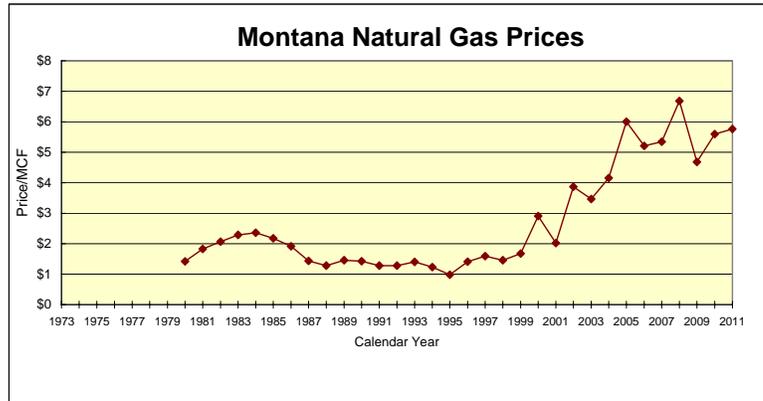
Figure 5



In the most recent IHS Global Insight forecasts, West Texas Intermediate (WTI) oil prices are expected to average \$101.22 in calendar 2008, and then drop to \$65.89 in calendar 2009. WTI prices are expected to decline to \$48.25 and \$62.50 per barrel for calendar 2010 and 2011, respectively. While Montana wellhead prices are considerably lower than the WTI price, Montana prices are expected to follow a similar trend.

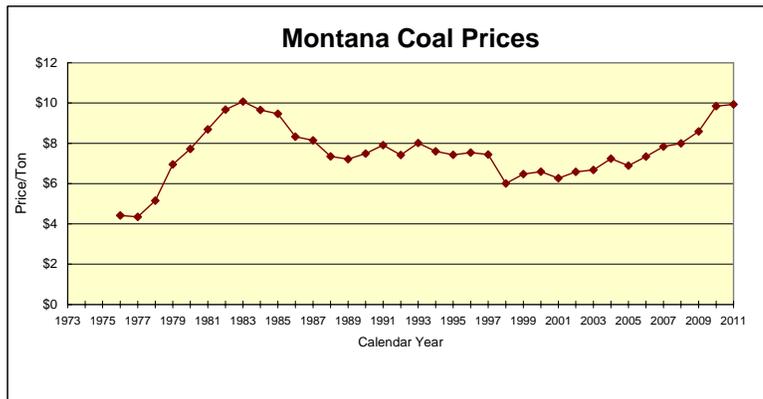
Natural gas prices at the wellhead in the US averaged \$4.00 per MCF in calendar 2001 and increased to \$6.22 by calendar 2007. IHS Global Insight is forecasting average well head natural gas prices at \$7.69 in calendar 2008, \$5.66 in calendar 2009, \$6.80 in calendar 2010, and \$7.27 in calendar 2016. While Montana wellhead prices are usually lower than the US average well head price, Montana prices are expected to follow a similar trend.

Figure 6



Western U.S. coal production, which has grown steadily since 1970, is expected to continue to increase through 2011. Strong growth, combined with limited improvement in coal mining productivity, are expected to result in minemouth price increases of 0.9 percent annually from 2008 through 2011.

Figure 7



Between the years of 1998 and 2006, the Montana price for coal remained relatively constant, but according to recent tax return data, coal prices have started to rise. Montana coal price is expected to increase over the 2011 biennium.

Key Risks to Economic Assumptions

Income – As unemployment increases nationwide and, to a small extent, in Montana, wages and salaries will decline. Since wages and salaries are the largest component of income tax revenue (Montana largest general fund revenue source), even a minimal decline would have substantial impact on general fund revenue.

Interest Rates – The federal funds rate set by the Federal Reserve is now between 0.25 and 0 percent. It cannot get much lower and may increase if inflation shows signs of life. Low rates are a double-edged sword. Low rates may stimulate the economy activity which in turn increases employee and wages and salaries. On the other hand, Montana's earnings from trust funds and excess cash decrease in a fairly quick response to the reduction. Investment income reported for income tax purposes also declines, although this effect is delayed.

Corporate Profits - In light of the current national recession, the greatest risk could be the impact of the net operating loss (NOL) carryback 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 carryback to each of the three taxable periods preceding 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 carryback. 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 recession deepens and lengthens, demand for energy commodities, primarily oil and natural gas, may be slow to recover or even deteriorate. This could lengthen the time of low prices or depress them even further.

DEMOGRAPHIC TRENDS

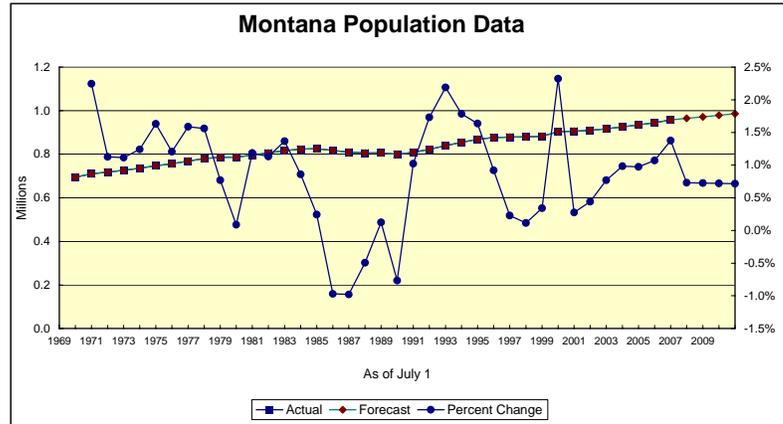
Montana, with a total area of 147,046 square miles, is the fourth largest state. Its population of 957,861 (2007 estimate) places Montana 44th among all 50 states. Montana has 6.6 persons per square mile while the U.S. average is 85.3. A relatively small population in a very large state contributes to Montana being a great place to live, but it also presents many challenges in delivery of government services and in the overall economic well-being of the state.

POPULATION TRENDS

Montana's population has historically demonstrated slow growth. In the 35 years between 1970 and 2005, the annual rate of growth of the state population was 0.9 percent. However in 2006 and 2007, population growth increased by 43 percent, with annual growth of 1.2 percent. Growth through the next biennium, as shown in Figure 8, is estimated at about 0.7 percent annually.

Population statistics are used to develop estimates for many of the tax revenue sources including beer, wine, liquor, and cigarette taxes. In addition, the size of the population indirectly affects the profitability of all businesses and the employment levels statewide.

Figure 8



Montana’s Aging Population Trend

One of the most significant events that is beginning to surface in Montana is the projected increase in the aging population. Between 1940 and 2000, the percentage of Montana’s population 65 and over doubled, and it is expected to double again by 2030, when Montana will have the fifth highest percentage of population 65 and older in the nation.

There are a couple factors causing the increasing of the elderly population. First, according to research performed by George W. Haynes, Myles J. Watts, and Douglas J. Young, in a report titled, *Project 2030 Montana’s Ageing Population*, the life expectancy at age 65 increased from 13 years to 19 years between 1940 and 2005. Additionally the baby-boomer generation, those born between 1946 and 1965, will soon begin to reach the age of 65, swelling the ranks of the elderly. Montana, like other state and local governments, will need to address the issues relative to changing demographics.

With a growing elderly population, the legislature will need to address how the working-age population can support an older population. Currently, there are 4.3 people of working age to each retiree (person of age 65 and over). This statistic is expected increase substantially by 2030, when there will only be 1.2 people of working age to each retiree. The level of income earned by the retired population and ultimately how much they will pay in taxes could have a substantial impact on state government finances.

A Proposed Study

During the 2007-08 interim, the RTIC and the LFC formed a subcommittee to discuss the implications of the aging population. Their work resulted in a study

proposal which is being brought to the legislature via HB 81. This legislation would create an interim committee to conduct a study of the potential long-term effects of demographic, economic, social, and other trends in Montana. State and local governmental programs and services, and state and local revenue systems would be studied.

BUDGETARY IMPACTS

The projected demographic changes have budgetary impacts on both revenues and disbursements. Changes in population directly affect consumption type revenue sources such as cigarettes, liquor, and driver's licenses, but also impacts other tax sources such as income and insurance taxes. As related to state disbursements, the increasing elderly population will require more state provided health related services. The funding of aging services and children's health insurance are two of the primary areas of concern related to demographic changes.