STATE FINANCES - HISTORICAL PERSPECTIVE

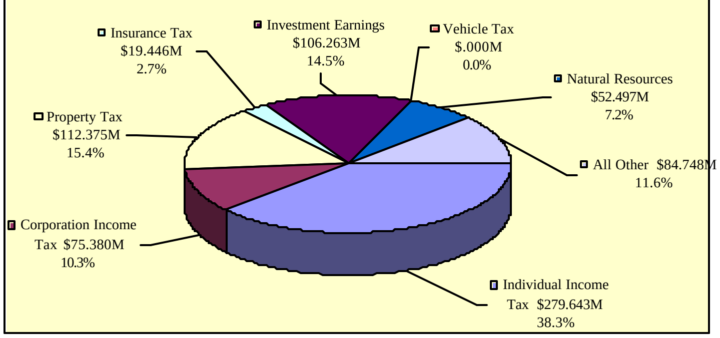
REVENUE HISTORY

The recent history of finances in the state of Montana has followed an upward trend. On both the revenue and expenditure side, Montana state finances have increased significantly.

From fiscal 1990 through fiscal 2002, the relative importance of the revenue components has changed only slightly. In fiscal 1990 as now, the largest component of general fund revenue was collections from individual income tax. As shown in Figure 1, individual income tax made up 38.3 percent of total general fund revenues. Property tax collections were next, with collections amounting to 15.4 percent of all general fund revenues. Investment earnings follow, adding 14.5 percent of the collections to the revenue base.

Figure 1

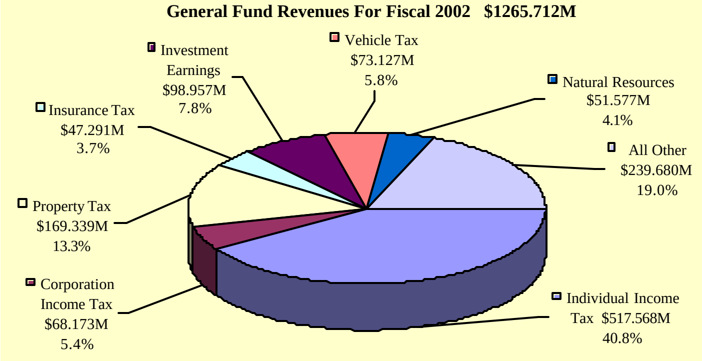
General Fund Revenues For Fiscal 1990 $730.352M



In fiscal 2002, individual income tax collections increased slightly in terms of its relative importance to the general fund, now making up 40.8 percent of total general fund collections. Property tax collections are only 13.3 percent of general fund collections, while investment earnings fell in relative importance to only 7.8 percent of total revenues. Total general fund revenues are shown in Figure 2.

Figure 2

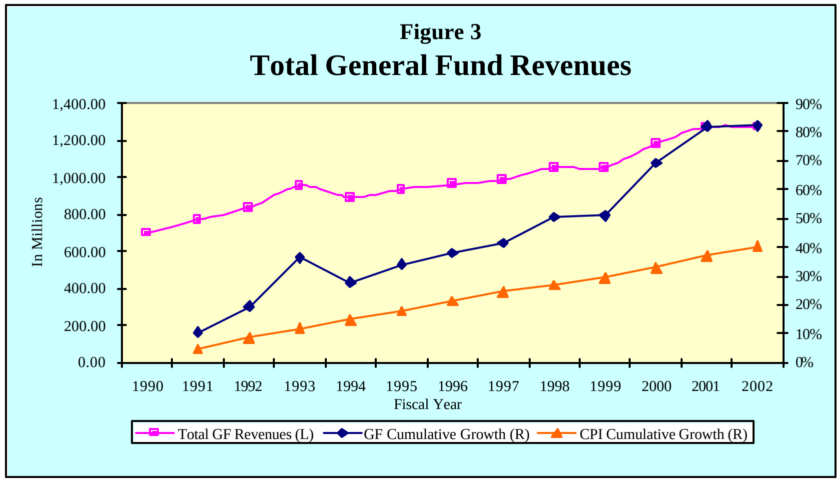
General Fund Revenues For Fiscal 2002 $1265.712M



Over the 13-year period spanning from fiscal 1990 through fiscal 2002, revenues have increased substantially. General fund revenues during the period have increased by over $535.3 million, from $730.4 million in fiscal 1990 to $1,265.7 million in fiscal 2002. This represents an increase of more than 73.3 percent in nominal terms. In real terms, when adjusted for inflation, the change is over 33.0 percent. This rate of growth is significant and can be traced almost exclusively to the increases in individual income tax and property tax collections. Over the same period, individual income tax has increased by 34.9 percent, and property tax has increased by 10.4 percent in real terms. Figure 3 depicts the cumulative increases of general fund revenues in both dollar and percent terms for the 13-year period.

EXPENDITURE HISTORY

General fund expenditures have also increased substantially since fiscal 1990. A portion of the increase is attributable to increased state spending due to inflationary pressures. Further increases can be explained by growth in human service caseloads, prison population, and average number belonging (ANB) increases.



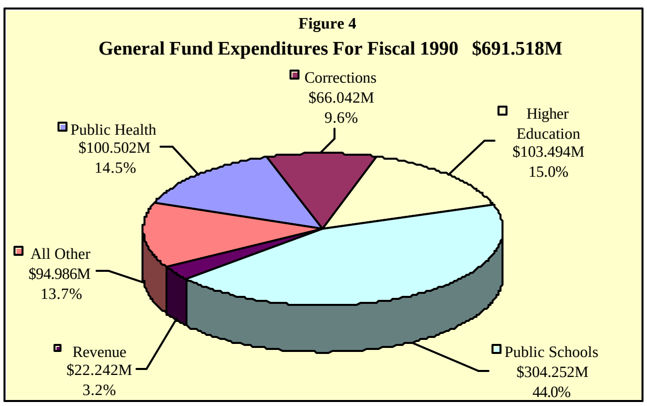
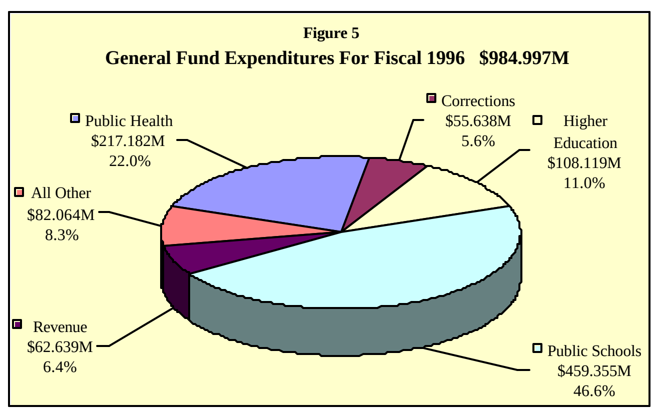
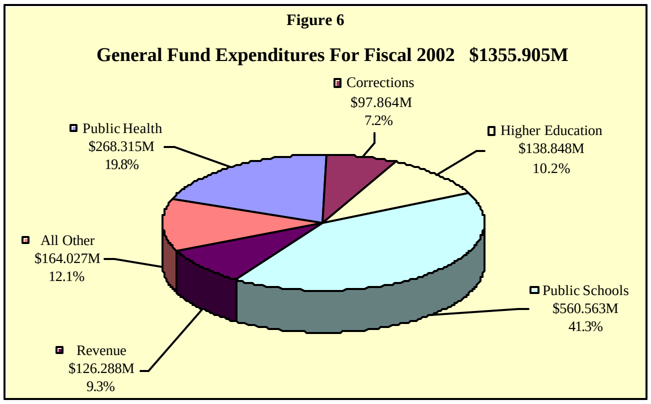


Figure 4 shows the general fund expenditure components for fiscal 1990, along with the dollars expended and the percent of total general fund spending. In all years, expenditures for public schools are the greatest portion of total general fund expenditures, consuming 44.0 percent of general fund dollars. In fiscal 1990, expenditures for higher education were the second highest area, utilizing 15.0 percent of general fund revenues. At that time, Public Health expenditures were only 14.5 percent of total general fund spending.

In fiscal 1996, the legislature reorganized public health entities, which moved health service related functions into one agency. Consequently, general fund expenditures for public health accounted for 22.0 percent of total general fund expenditures. The expenditures for higher education increased in the period between fiscal 1990 and fiscal 1996 by 4.5 percent and dropped to the third highest area in general fund terms. Public school funding was also increased in fiscal 1996. Consequently, general fund support for schools increased by 51.0 percent and account for 46.6 percent of total general fund expenditures. Figure 5 shows the fiscal 1996 general fund expenditures.



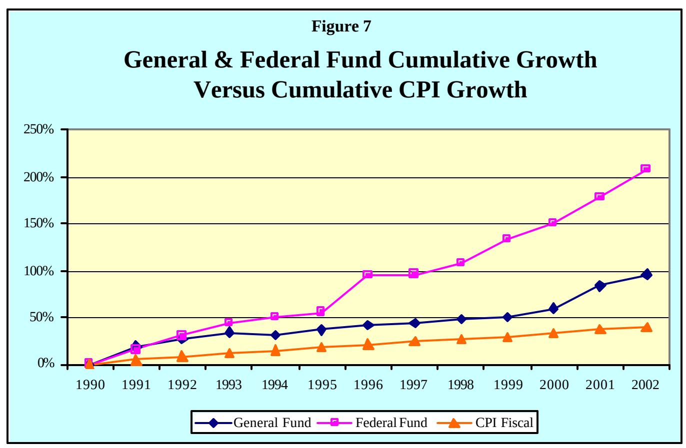
By fiscal 2002, public school support dropped in relative weight to the general fund support. As seen in Figure 6, public schools consumed 41.3 percent of available general fund dollars. Public health, the second largest consumer, expended 19.8 percent of the total general fund. Higher education share of general fund expenditures by fiscal 2002 dropped to 10.2 percent of the total.



During the 6-year period between fiscal 1996 and fiscal 2002, total general fund expenditures have increased from $985.0 million to $1,355.9 million. This corresponds to a nominal increase of 37.7 percent but an increase in real terms of 19.0 percent. The greatest portion of this increase is seen in the three program area, public schools, public health, and higher education. Since fiscal 1996, public school expenditures have increased from $459.4 million to $560.6 million, an increase of 11.9 percent in real terms. Public health expenditures have increased from $217.2 million to $268.3 million, increasing over 4.8 percent in real terms. Higher education has experienced increases from $108.1 million to $138.8 million in the six years. This represents a 9.7 percent increase in real terms.

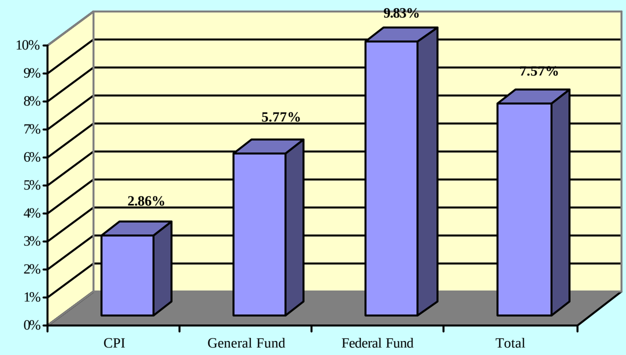
FEDERAL FUND EXPENDITURES

While general fund expenditures have increased cumulatively over 42.0 percent in real terms since fiscal 1990, federal funds have increased by 167.8 percent. Montana has become substantially more dependent upon federal funds to support its expenditures, as illustrated in Figure 7.



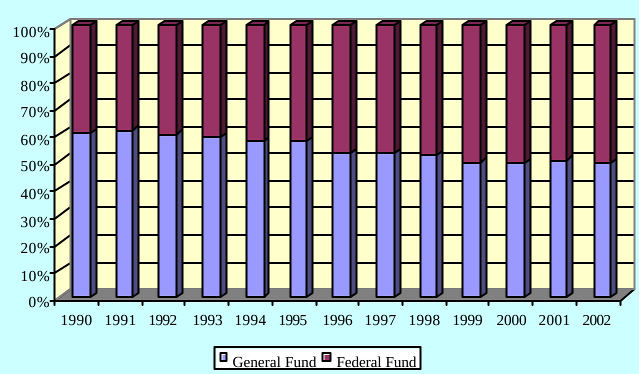
Annual growth for the general fund has been 5.8 percent in nominal terms over the 13-year period. Nominal annual growth in federal funds is 9.8 percent. The average annual nominal growth for both fund sources is 7.6 percent, or 4.7 percent when adjusted for inflation, as shown in Figure 8.

Figure 8
1990-2002 Average Annual Growth



In Figure 9, the ratio of general fund to federal fund has changed significantly since fiscal 1990. Where federal funds paid for approximately 39.3 percent of state expenditures in fiscal 1990, they now support over half.

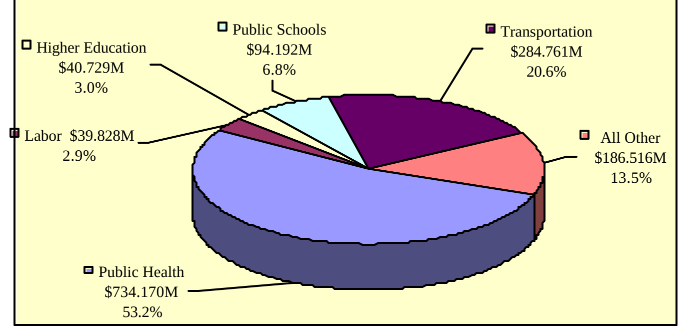
Figure 9
General and Federal Fund Expenditure Ratio



The largest area of federal support goes to public health expenditures. In fiscal 2002, Montana received over $734.2 million in federal aid for public health programs. This corresponds to 53.2 percent of the federal funds received. Transportation received $284.7 million in federal aid or 20.6 percent of all federal funds, and public schools received $94.2 million or another 6.8 percent of the federal funds provided to Montana. Figure 10 presents the entire breakout of federal fund expenditures for fiscal 2002.

General fund revenues and expenditures and federal funds have all increased since fiscal 1990. Typically, the increases have surpassed inflation. The state has directed the increased revenues to all budgets, but the greatest increases, in dollar terms, have been expended in the largest budgets, public schools, public health, and higher education. Finally, Montana has grown increasingly dependent on federal funds to support these programs.

Figure 10
Federal Fund Expenditures For Fiscal 2002 $1380.196M

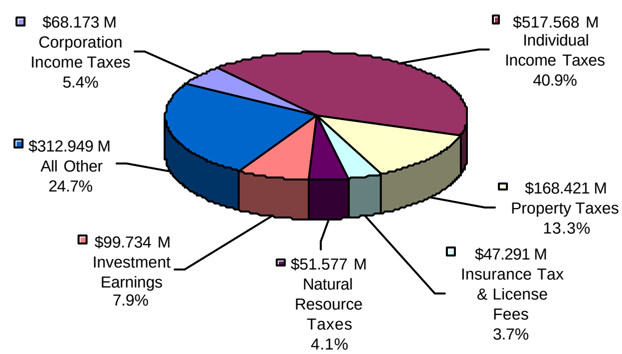


GENERAL FUND ANALYSIS

INTRODUCTION

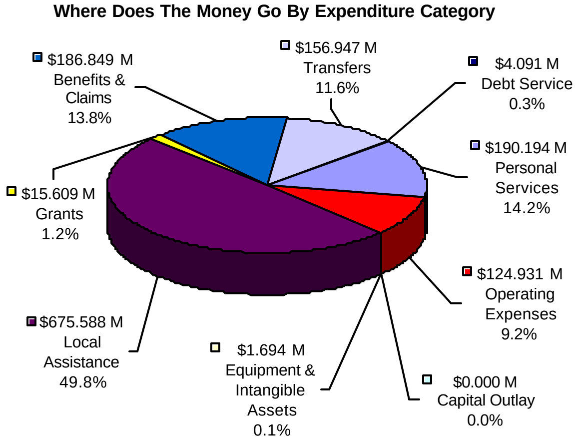
The state general fund is the primary account that funds a significant portion of the general operations of state government and is often referred to as the state's checking account. This account has grown from slightly less than $700 million in fiscal 1990 to over $1.3 billion in fiscal 2002, or approximately 5.8 percent annually. Figure 1 shows where the money in this account comes from by major revenue category, while Figure 2 shows how the money is expended by major expenditure category. The information shown in both figures represents actual data for fiscal 2002.

Figure 1
Total General Fund Revenue Fiscal 2002
Where Does The Money Come From By Revenue Category



In fiscal 2002, almost 60 percent of total general fund revenues came from income and property taxes. Total revenues to the account for the 2005 biennium are estimated to exceed $2.5 billion, which is an increase of $52.7 million, or 2.1 percent from the 2003 biennium. House Bill 7, enacted during the August special legislative session, created a new state special guarantee account, which receives deposits of interest and income, timber, and mineral royalty revenues from school lands. These monies were previously deposited in a sub-account within the general fund. This means that revenues for the 2003 biennium include school land revenue for fiscal 2002 that have been removed for fiscal 2003. If the fiscal 2002 amount is adjusted to exclude this revenue, the adjusted general fund growth rate is projected to be 4.2 percent from the 2003 to 2005 biennium.

Figure 2
Total General Fund Fiscal 2002
Where Does The Money Go By Expenditure Category



Interestingly, about 23.4 percent of the general fund revenue is expended for personal services and operating costs with most of the remainder disbursed for local assistance, human service benefits, and grants. This indicates that the cost of government is weighted heavily towards local assistance (local government entities including public schools) and direct human service benefits. Total general fund disbursements represent approximately 38 percent of all state expenditures in the general, state special, federal special, and selected proprietary fund types.

Balancing general fund appropriations against anticipated revenues is a major challenge of each legislative session and requires a significant coordination between the taxation and appropriation committees. Based on revenue estimates adopted by the Revenue and Taxation Interim Committee (RTIC) on November 19, 2002, there are insufficient revenues to support the executive <u>present law</u> budget recommendations, leaving a ending fund balance of a negative $232.0 million.

There are insufficient revenues to accommodate all of the executive <u>new proposals</u> including the executive's recommended ending fund reserve of $50.1 million. If the total Executive Budget were funded as requested, the ending balance in the general fund would be $36.6 million. One of the reasons for this reduced balance is that the projected balance uses the final revenue estimate recommendations of the RTIC. The Executive Budget was based on higher revenue estimates developed by the executive's staff. The result is that the balanced budget as submitted by the executive does not achieve the recommended $50.1 million reserve when using RTIC general fund revenue estimates.

This section of the budget analysis provides a summary of the general fund account as projected through the 2003 biennium. It begins with a reconciliation of the current (2003 biennium) projected fund balance in order to arrive at the beginning balance for the 2005 biennium.

This section is followed by a summary of the 2005 biennium economic assumptions and associated revenue estimates as adopted by RTIC, including a graphic view of the significant revenue components. Additionally, a summary of the projected present law general fund balance using RTIC revenue estimates is shown. A projected general fund balance is also shown when the executive new proposals are included.

Finally, the differences between the executive proposed fund balance and the balance using RTIC revenue estimates and LFD statutory disbursement and reversion computations are explained.

2003 BIENNIUM GENERAL FUND PROJECTION

After completion of the Fifty-seventh Legislature, the unreserved ending general fund balance for the 2003 biennium was projected to be $53.8 million (Figure 3). This balance was based on: 1) revenue estimates adopted in HJR 2; 2) LFD statutory appropriation and reversion estimates; 3) all general fund appropriations authorized by the legislature; and 4) the estimated impacts of all enacted revenue legislation. The Fifty-seventh Legislature did not budget for any supplemental or emergency appropriations.

Figure 3
Comparison of 2003 Biennium General Fund Balance
Post Regular Session Budget vs. Post Special Session Budget
In Millions

	Regular Session 2003 Biennium	Special Session 2003 Biennium	Difference 2003 Biennium
Beginning Fund Balance	**$110.729**	**$172.897**	**$62.168**
Revenues			
Current Law Revenue	2,677.566	2,494.059	(183.507)
Total Funds Available	**$2,788.295**	**$2,666.956**	**($121.339)**
Disbursements			
General Appropriations	2,274.123	2,181.256	(92.867)
Statutory Appropriations	92.195	278.558	186.363
Local Assistance Appropriations	326.739		(326.739)
Miscellaneous Appropriations	8.483	157.593	149.110
Non-Budgeted Transfers	31.930	30.133	(1.797)
Continuing Appropriations		9.262	9.262
Supplemental Appropriations			
Feed Bill Appropriations		0.498	0.498
Executive Reductions		(16.148)	(16.148)
Legislative Reductions		(0.350)	(0.350)
Anticipated Reversions	(6.027)	(14.941)	(8.914)
Total Disbursements	**$2,727.443**	**$2,625.861**	**($101.582)**
Adjustments		(1.163)	(1.163)
Reserved Ending Fund Balance	**$60.852**	**$39.932**	**($20.920)**
2003 Session Feed Bill Reserve	7.028	7.200	0.172
2003 Session Supplemental Reserve		5.580	5.580
Unreserved Ending Fund Balance	**$53.824**	**$27.152**	**($26.672)**
Net Operations	**($56.905)**	**($144.582)**	**($87.677)**

Figure 3 also shows the projected ending general fund balance for the 2003 biennium after completion of the August 2002 special legislative session. The legislature was called into special session by the Governor when the executive determined that the spending reductions authorized under 17-7-140, MCA would not be sufficient to maintain a general fund balance equal to one percent of all general fund appropriations. The August Special Session legislature adjourned with a projected balance of $27.2 million.

As Figure 4 shows, the revised unreserved general fund balance at the end of the 2003 biennium is now projected to be $4.4 million. This revised projection is based on: 1) revenue estimates adopted by RTIC on November 19, 2002; 2) LFD statutory appropriation and reversion estimates; and 3) supplemental appropriation recommendations by the executive. This projected balance equals 0.27 percent of anticipated revenues for the 2003 biennium and is $22.8 million below the balance anticipated during the August 2002 special legislative session.

Figure 4
Comparison of 2003 Biennium General Fund Balance
Post Special Session Budget vs. LFD Budget Analysis
In Millions

	Special Session 2003 Biennium	Budget Analysis 2003 Biennium	Difference 2003 Biennium
Beginning Fund Balance	**$172.897**	**$172.897**	
Revenues			
Current Law Revenue	2,494.059	2,474.121	(19.938)
Total Funds Available	**$2,666.956**	**$2,647.018**	**($19.938)**
Disbursements			
General Appropriations	2,181.256	2,179.145	(2.111)
Statutory Appropriations	278.558	275.058	(3.500)
Local Assistance Appropriations			
Miscellaneous Appropriations	157.593	152.511	(5.082)
Non-Budgeted Transfers	30.133	27.812	(2.321)
Continuing Appropriations	9.262	8.026	(1.236)
Supplemental Appropriations		15.686	15.686
Feed Bill Appropriations	0.498	8.622	8.124
Executive Reductions	(16.148)		16.148
Legislative Reductions	(0.350)		0.350
Anticipated Reversions	(14.941)	(23.678)	(8.737)
Total Disbursements	**$2,625.861**	**$2,643.182**	**$17.321**
Adjustments	(1.163)	0.521	1.684
Projected Ending Fund Balance	**$39.932**	**$4.357**	**($35.575)**
2003 Session Feed Bill Reserve	7.200		(7.200)
2003 Session Supplemental Reserve	5.580		(5.580)
Unreserved Ending Fund Balance	**$27.152**	**$4.357**	**($22.795)**

The decrease in the projected general fund balance is due to several factors that have transpired since the adjournment of the August special session. Total general fund revenues are expected to be $19.9 million less than anticipated, while disbursements are expected to be $3.9 million more than authorized by the regular and special session legislatures. Fund balance adjustments that increase the fund balance are expected to be $1.7 million more than anticipated.

The decreased revenue condition ($19.1 million) can be attributed to the factors shown in Figure 5. As shown in Figure 5, most of the revenue adjustments were due to new data becoming available that was not available during the August special legislative session. For example, individual income tax returns for calendar year 2001 became available on November 1. Prior to this time, revenue estimates were developed using calendar 2000 tax return information.

The primary reasons for the increased disbursements ($3.9 million) are: 1) increased supplemental appropriations of $10.1 million (see page 91, for more details) and 2) reduced miscellaneous and statutory appropriations and transfers of $5.6 million (see page 129 for more details). As Figure 5 shows, the combined impact of lower revenues, greater disbursements, and a positive fund balance adjustment is a net decrease in the projected fund balance of $22.8 million for the 2003 biennium.

Figure 5
Significant General Fund Adjustments For 2003 Biennium
Special Session vs. Budget Analysis
In Millions

General Fund Component		2003 Biennium Adjustment	Explanation
Revenue Adjustments		**($19.938)**	
Individual Income Tax	(4.220)		More Current Data
Corporation Income Tax	(9.281)		More Current Data
Treasury Cash Account Interest	(5.138)		Reduced Interest Rates
All Other Revenue	(1.299)		Various Reasons
Expenditure Adjustments		**4.541**	
Additional Supplementals	10.100		DPHHS/OPI/DNRC
Other Appropriation Adjustments	(5.559)		Statutory/Transfers/Miscellaneous
Fund Balance Adjustments		**1.684**	Fiscal Year End 2002 Adjustments
Total		**($22.795)**	

2005 BIENNIUM GENERAL FUND OUTLOOK

INTRODUCTION

This upcoming legislative session is probably the most difficult budget situation the state has faced in a number of years. Not only are anticipated revenues significantly below the level of funding needed to fund "present law" services, the projected ending fund balance for the current biennium is below the statutory minimum as defined in 17-7-140, MCA. Because this balance is so low, the legislature will not be able to use previous excess fund balances to help balance the 2005 biennium budget.

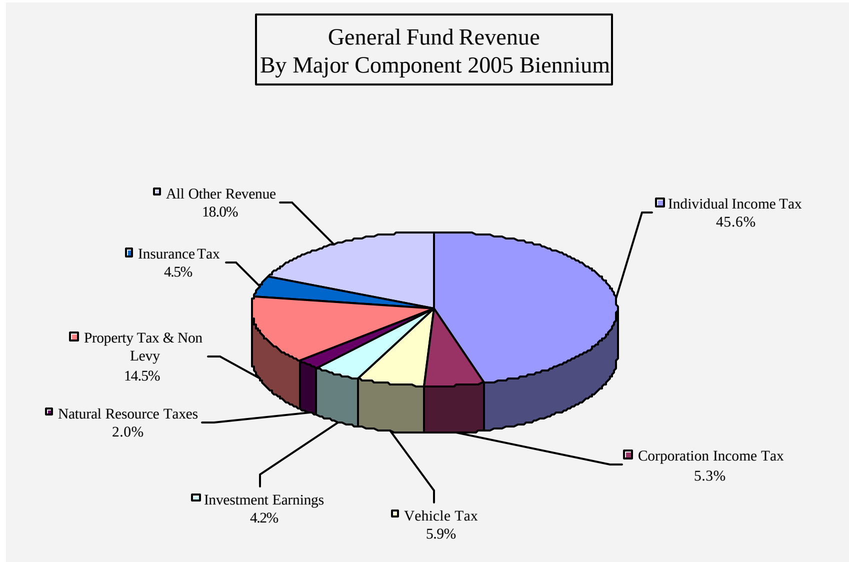
In addition, the current economic uncertainty facing the national as well as world economies is significant. A sluggish national economy combined with the continued threat of terrorism attacks and a potential U.S. war with Iraq makes the job of developing prudent revenue estimates an extremely difficult task. Artificially low estimates may cause the legislature to reduce state services that fall below the legislature's priority line. Estimates that are too high may create the temptation for the legislature to fund state services that the state cannot afford. Obviously, the last scenario would result in spending reductions by the executive and/or a special session.

As delineated in Section 5-18-107(1) (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 5-12-307(7) 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 committee in performing its revenue estimating duties...".

The next section of the report highlights the significant economic assumptions used by the RTIC to develop the revenue estimate recommendations contained in HJR 2, the revenue estimate resolution. Each assumption is discussed and is graphically portrayed to give the reader a perspective of the historical trend versus the forecast amount.

GENERAL FUND REVENUE IMPLICATIONS

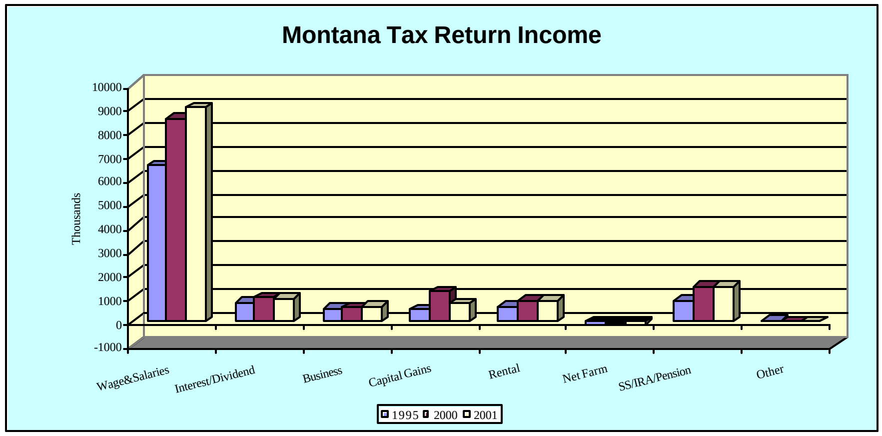
Montana's fiscal outlook for revenue growth is less optimistic than in previous biennia. The key economic assumptions targeted as most affecting state government receipts are Montana total income, employment or population levels, inflation rates, corporate profits, property values, interest rates, and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



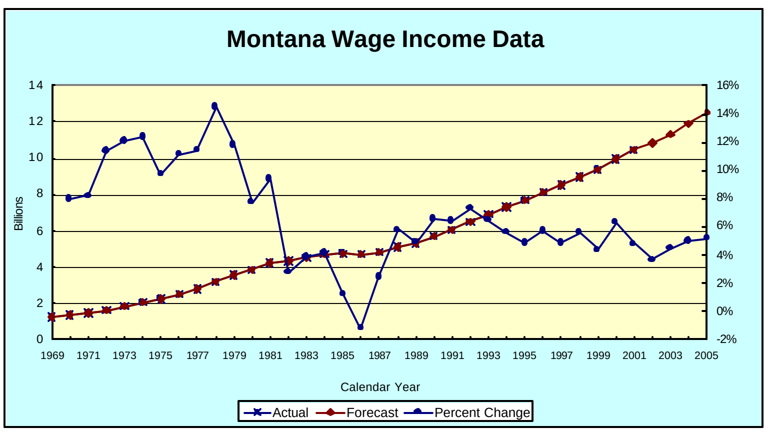
Major Category	2003 Biennium Estimate Millions	2005 Biennium Estimate Millions	Percent Change
Individual Income Tax	$1,044.968	$1,151.213	10.17%
Corporation Income Tax	121.987	134.005	9.85%
Vehicle Tax	146.637	150.121	2.38%
Investment Earnings	146.593	105.489	-28.04%
Natural Resource Taxes	55.807	51.030	-8.56%
Property Tax & Non Levy	342.616	366.599	7.00%
Insurance Tax	98.737	114.479	15.94%
All Other Revenue	516.775	453.773	-12.19%
Total General Fund	**$2,474.121**	**$2,526.709**	**2.13%**

As shown in the figure at the right, individual income tax, corporation income tax, property tax, vehicle tax, and investment earnings are expected to contribute over 75 percent to the total general fund revenue stream during the 2005 biennium. Total general fund revenues for the 2005 biennium are projected to increase 2.1 percent over the 2003 biennium projections. The comparative change by major revenue category is shown at the bottom of the figure. House Bill 7, enacted during the August special legislative session, created a new state special guarantee account, which receives deposits of interest and income, timber, and mineral royalty revenues from school lands. These monies were previously deposited in a sub-account within the general fund. This means that revenues for the 2003 biennium include school land revenue for fiscal 2002 that has been removed for fiscal 2003. If the fiscal 2002 amount is adjusted to exclude this revenue, the adjusted general fund growth rate is projected to be 4.2 percent from the 2003 to 2005 biennium.

Montana Total Income

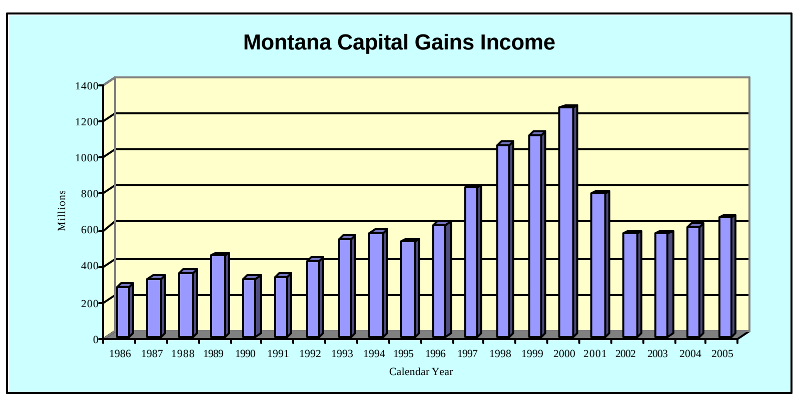


The total of all income sources listed on the Montana personal income tax form is referred to as Montana total income. The Department of Revenue tracks income from 11 different components, including wages, interest, dividends, business, capital gains, supplemental, rental, farm, social security, IRA 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 65.2 percent of total income. In calendar 2001, it contributed 65.8 percent, or $9.013 billion. The average annual growth from calendar 1990 to 2001 has been 5.5 percent.



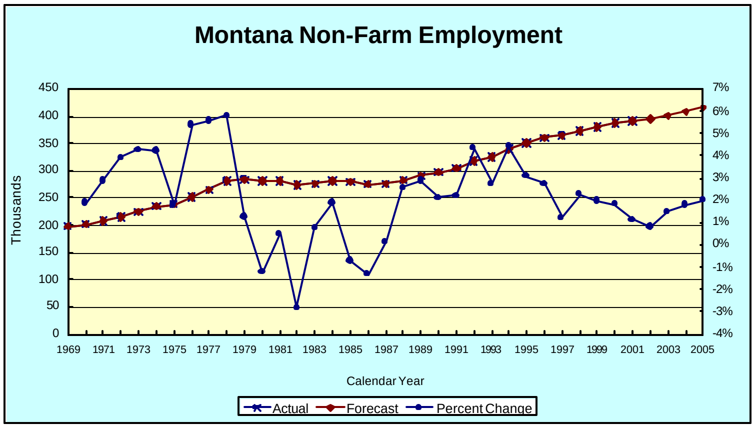
In recent times, capital gains income has been the focus of much conversation and speculation. Capital gains income has increased in relative importance over the decade. In 1990, capital gains made up only 4.2 percent of total income, with reported income of $318 million. In 2000, capital gains contributed 9.2 percent of total income, at $1.260 billion. In 2001, capital gains receded to 5.7 percent of total income, with income at $786 million. That equates to a reduction of over 37.6 percent over the previous year, or $474 million in income.

For the 2005 biennium, growth in wages and salaries is expected to be slow in calendar 2002 and 2003, while gradually increasing to about 5 percent by calendar 2005. Capital gains is projected to decline an additional 28 percent in calendar 2002 and remain flat in calendar 2003, For the last two years of the forecast period, capital gains are estimated to rebound to a historic growth rate of 7.5 percent per year.



Montana Employment

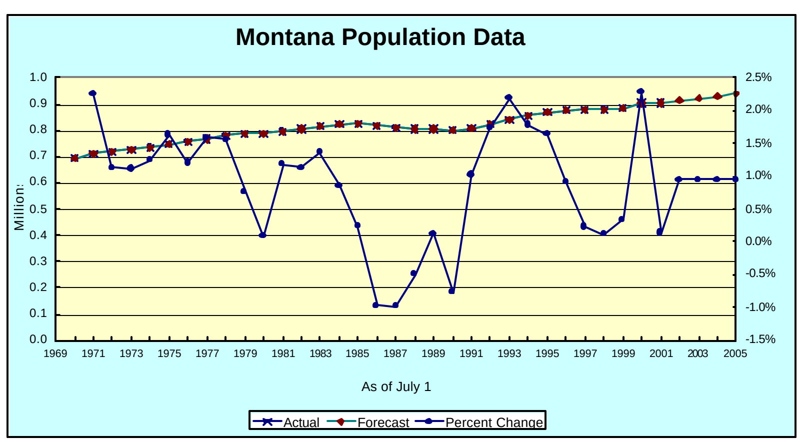
Like personal income, employment plays a key role in shaping the estimate of the individual income tax revenues. Furthermore, the information allows a view into the changing employment climate in Montana, where jobs are migrating, and how incomes might be altered. Dr. Paul Polzin, Director of the



Montana Bureau of Business and Economic Research, is one of the several sources that provide information concerning the changing industrial make up of the state. Specific detailed data is gathered from the Montana Department of Labor, Research and Analysis Division. The statistics collected include employment in manufacturing, mining, construction, public utilities, wholesale and retail, finance, insurance, real estate, services, and government sectors. Average annual growth since 1996 has been 2.0 percent. The estimates for future growth, during the forecast period, reflects a gradual increase of 0.8 percent in calendar 2002 to 1.8 percent by calendar 2005. Over the past decade, the largest area of growth was seen in construction employment, which experienced 98.1 percent positive growth. The service sectors follow, experiencing 55.4 percent growth in the same period. Mining is the only area that saw negative growth, with a workforce reduction of 12.7 percent since 1990.

Montana Population

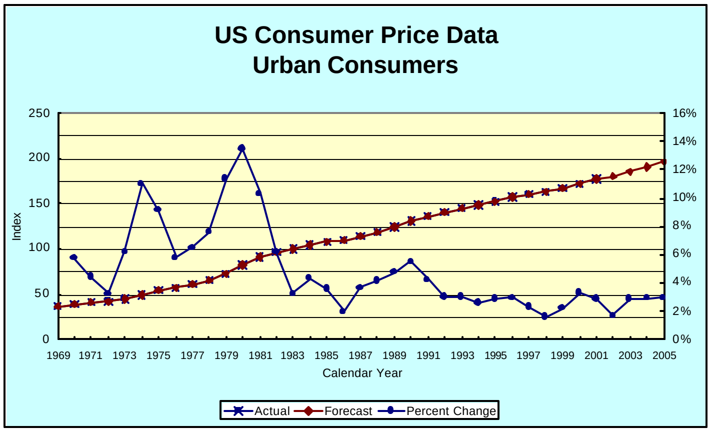
Population statistics are used to develop estimates for many of the revenue sources including beer, wine, liquor, and cigarette taxes. In addition to those sources where population has a direct effect, the size of the population indirectly affects the profitability of all businesses and the employment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



Consumption of any given item is highly reliant upon the size of the population, so accurate population forecasts are essential when determining tax revenues from the sources mentioned above. Historic population data is gathered from the U.S. Census department while projections are obtained from Woods and Poole Econometric Service. Since the early 1990's, Montana has experienced positive growth in total population varying between 0.1 percent in 1998 to 2.3 percent in 2000. Growth through the next biennium is estimated at 0.9 percent annually.

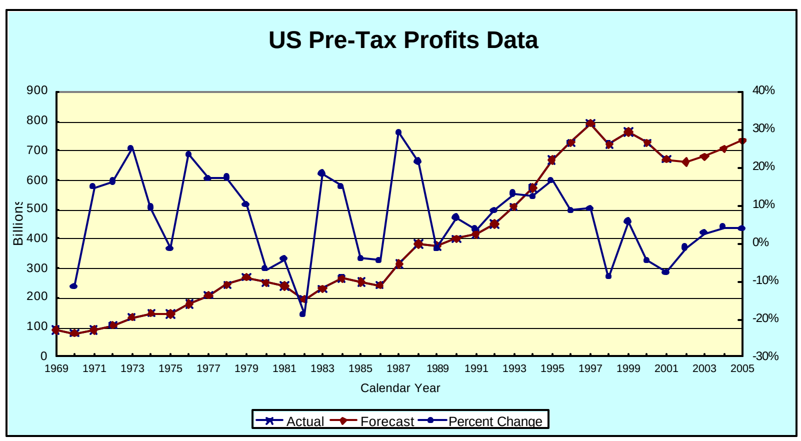
Inflation Rates

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.



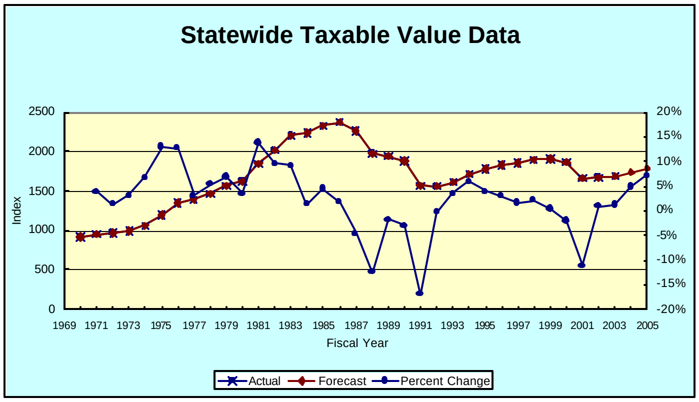
Since Montana's individual income tax structure is fully indexed by changes in the consumer price index, this assumption is critical in the formulation of the individual income tax forecasts. The U.S. Bureau of Labor Statistics provides the required CPI data for the all-urban customers data set. Since 1990, the average annual rate of inflation has been 3.0 percent. Global Insight Co. (formerly DRI-WEFA) estimates inflation during the next biennium at an average annual rate of 2.9 percent.

Corporate Profits

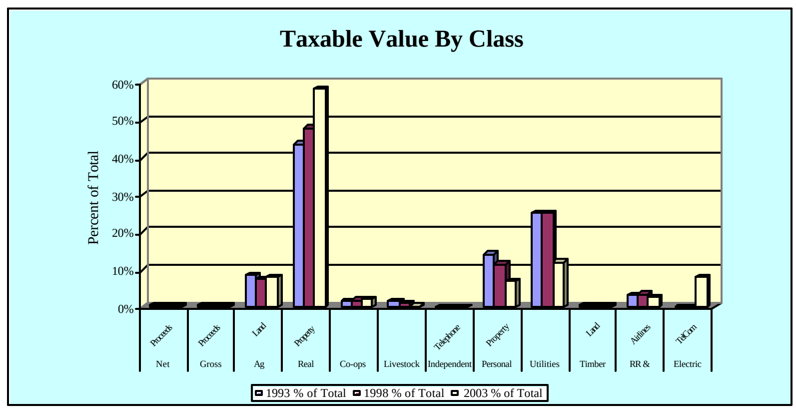


The profitability of corporate America is an important factor in estimating the revenues from the corporate license tax. There is a significant relationship between the profits reported by U.S. corporations and those taxed in Montana. Many of the large corporations operating in Montana are multi-state entities. During the most recent years, the reduction of corporate profits has translated to lower corporate license tax collections. According to Global Insight, between 1990 and 1997, U.S. corporation pre-tax profits increased by an annual average of 9.8 percent. However, from 1998 through 2001, profits have decreased by an average of 3.9 percent, the greatest decrease of 7.7 percent occurring in 2001. The reduction in corporate profits is projected to continue through 2002, at which time the outlook of corporate profitability is expected to begin a phase of slow improvement.

Property Values

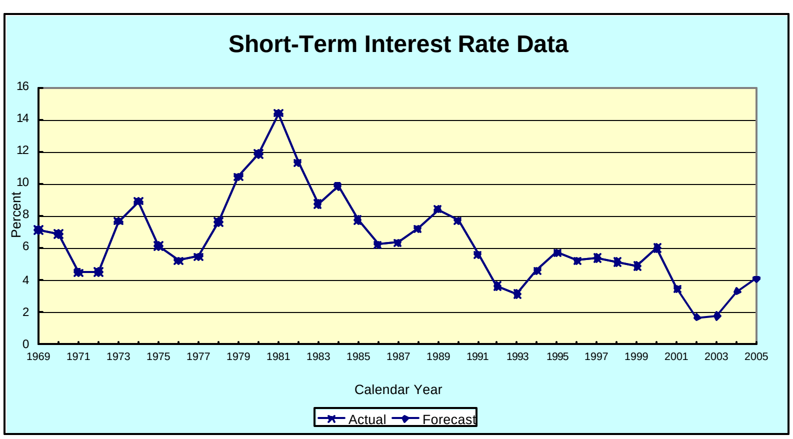


Change in statewide property values is the critical assumption behind the estimates for property taxes. Historic property values are obtained from the Montana Department of Revenue. Total statewide taxable value increased slowly during the first part of the 1990's but fell in both fiscal 2000 and 2001. This decline was primarily due to business equipment tax changes enacted by previous legislatures. Other reductions occurred in electrical generating and telecommunication property. Estimates for the 2005 biennium show that statewide property values will resume a slow upward trend during the next biennium. Since detailed information on the effects of property reappraisal will not be available from the Department of Revenue until December, the 2005 biennium forecasts do not include the potential impacts of reappraisal.

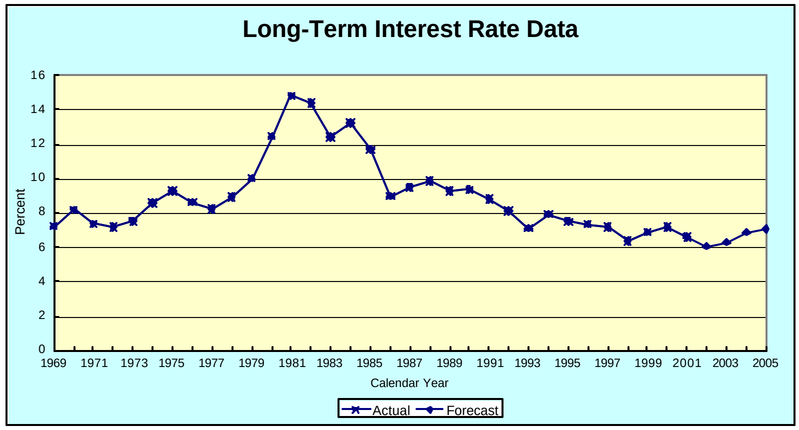


Significant changes have taken place in statewide property values since fiscal 1998. In that year, 48.0 percent of total statewide value was in class 4, residential and commercial property, and 11.5 percent of total value was in class 8, business equipment personal property. In fiscal 2003, the class 4 taxable value is expected to make up 58.4 percent of the total property tax base, while class 8 will be only 7.0 percent of the base.

Interest Rates

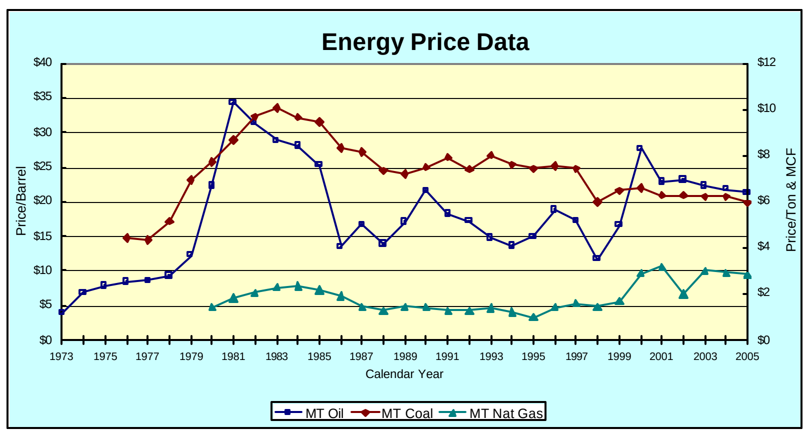


A large portion of Montana's revenues is derived from investment earnings from trust accounts and daily cash. Interest rates also affect the amount of investment income that is reported on individual income tax returns. As such, interest rates are a significant assumption when estimating future state revenues.



In addition to the state revenue impact, interest rates 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. 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 forecasted rates are obtained from Global Insight. Long-term rates are an average of Corporate Aaa and Baa bonds, 10 year Treasury (T) bonds, and 30 year T bonds. Short term rates are an average of 3 and 6 month corporate paper and 3 and 6 month T bills. Long and short term interest rates have been on the decline since January 2001, when the Federal Reserve began reducing the discount rate. Rates are expected to reverse and begin an upward trend during the forecast period.

Energy Prices



Energy prices are very important to Montana's economy. Montana's rich bounty of energy land holdings plays an important part in the state's employment and economic stability. Additionally, the taxation of those commodities adds significant revenues to the state's coffers. Coal, oil, and natural gas production are each taxed on the value of production. Global Insight supplies information on coal, oil, and natural gas prices. Among the specific energy price indexes forecast by Global Insight are the *U.S. Refiner's Acquisition Price,* the *U.S Minemouth Coal Price* and the *West Texas Oil Price.*

This information, plus conversations with industry experts, is used to develop Montana's energy prices. Since 1990, the price of Montana coal has decreased by 16.3 percent, oil has increased by 5.8 percent, and natural gas has increased by 123.5 percent. Estimates show a slow decline in the prices of all three of these commodities during the forecast period.

GENERAL FUND REVENUE ESTIMATES

Figure 6 and 7 show the RTIC general fund and non-general fund revenue recommendations for fiscal years 2003, 2004, and 2005. These recommendations are based on the major assumptions as discussed previously. From an economic perspective, these estimates reflect continuing slow growth in calendar 2002 and 2003 with a gradual recovery to more historic levels by calendar 2005.

Figure 6
Revenue and Transportation Interim Committee Recommendations
General Fund Revenue Estimates
In Millions

	Source of Revenue	Percent of Total	Actual Fiscal 2002	Estimated Fiscal 2003	Estimated Fiscal 2004	Estimated Fiscal 2005	Estimated Fiscal 02-03	Estimated Fiscal 04-05	Cumulative % of Total
1	Individual Income Tax	40.89%	$517.568	$527.400	$556.874	$594.339	$1,044.968	$1,151.213	42.24%
2	Property Tax	13.38%	169.339	173.277	180.179	186.420	342.616	366.599	56.08%
3	Corporation Income Tax	5.39%	68.173	53.814	64.782	69.223	121.987	134.005	61.01%
4	Vehicle Tax	5.78%	73.127	73.510	74.540	75.581	146.637	150.121	66.94%
5	Common School Interest and Income	3.87%	48.938	0.000	0.000	0.000	48.938	0.000	68.92%
6	Insurance Tax & License Fees	3.74%	47.291	51.446	56.038	58.441	98.737	114.479	72.91%
7	Coal Trust Interest	2.97%	37.605	36.825	37.249	37.920	74.430	75.169	75.92%
8	US Mineral Royalty	1.56%	19.772	22.679	23.407	22.903	42.451	46.310	77.63%
9	All Other Revenue	3.41%	43.216	25.808	18.783	18.877	69.024	37.660	80.42%
10	Tobacco Settlement	1.47%	18.647	19.025	3.105	3.182	37.672	6.287	81.95%
11	Telecommunications Excise Tax	1.55%	19.594	20.100	20.701	21.674	39.694	42.375	83.55%
12	Video Gambling Tax	3.45%	43.666	44.417	44.755	45.811	88.083	90.566	87.11%
13	Treasury Cash Account Interest	0.98%	12.414	10.811	13.476	16.844	23.225	30.320	88.05%
14	Estate Tax	1.09%	13.816	10.153	7.516	4.625	23.969	12.141	89.02%
15	Oil & Natural Gas Production Tax	1.02%	12.902	16.043	14.600	14.469	28.945	29.069	90.19%
16	Motor Vehicle Fee	2.15%	27.271	27.703	28.368	29.049	54.974	57.417	92.41%
17	Public Institution Reimbursements	1.13%	14.283	15.541	13.939	14.046	29.824	27.985	93.62%
18	Coal Severance Tax	0.67%	8.469	10.221	8.384	7.857	18.690	16.241	94.37%
19	Liquor Excise & License Tax	0.75%	9.514	9.854	10.239	10.624	19.368	20.863	95.15%
20	Cigarette Tax	0.62%	7.887	7.870	7.764	7.667	15.757	15.431	95.79%
21	Investment License Fee	0.39%	4.992	4.567	4.613	4.659	9.559	9.272	96.18%
22	Lottery Profits	0.59%	7.467	6.210	6.255	6.318	13.677	12.573	96.73%
23	Liquor Profits	0.44%	5.600	5.637	5.399	5.365	11.237	10.764	97.18%
24	Nursing Facilities Fee	0.47%	5.918	5.723	5.670	5.624	11.641	11.294	97.66%
25	Foreign Capital Depository Tax	0.00%	0.000	0.000	0.000	0.000	0.000	0.000	97.66%
26	Electrical Energy Tax	0.33%	4.197	4.329	4.408	4.483	8.526	8.891	98.00%
27	Metalliferous Mines Tax	0.26%	3.329	4.842	2.967	2.753	8.171	5.720	98.33%
28	Highway Patrol Fines	0.32%	4.062	4.142	4.224	4.308	8.204	8.532	98.66%
29	Public Contractors Tax	0.26%	3.267	2.679	3.354	3.356	5.946	6.710	98.90%
30	Wholesale Energy Tax	0.23%	2.906	3.373	3.432	3.492	6.279	6.924	99.16%
31	Tobacco Tax	0.17%	2.183	2.262	2.353	2.444	4.445	4.797	99.34%
32	Driver's License Fee	0.20%	2.580	2.355	2.373	2.391	4.935	4.764	99.53%
33	Railroad Car Tax	0.12%	1.490	1.577	1.688	1.681	3.067	3.369	99.66%
34	Wine Tax	0.10%	1.232	1.264	1.283	1.302	2.496	2.585	99.76%
35	Beer Tax	0.22%	2.784	2.918	3.058	3.205	5.702	6.263	99.99%
36	Telephone License Tax	0.02%	0.212	0.033	0.000	0.000	0.245	0.000	100.00%
37	Long Range Bond Excess	0.00%	0.000	0.000	0.000	0.000	0.000	0.000	100.00%
	Total General Fund	100.00%	$1,265.713	$1,208.408	$1,235.776	$1,290.933	$2,474.121	$2,526.709	100.00%

Figure 7
Revenue and Transportation Interim Committee Recommendations
Non-General Fund Revenue Estimates
In Millions

	Source of Revenue	Percent of Total	Acutal Fiscal 2002	Estimated Fiscal 2003	Estimated Fiscal 2004	Estimated Fiscal 2005	Estimated Fiscal 02-03	Estimated Fiscal 04-05	Cumulative % of Total
1	Diesel Tax	17.83%	$58.261	$59.180	$60.041	$60.903	$117.441	$120.944	18.14%
2	Federal Forest Receipts	4.12%	13.475	13.583	13.775	13.976	27.058	27.751	22.30%
3	Gasoline Tax	40.32%	131.731	132.446	133.185	133.918	264.177	267.103	62.35%
4	GVW and Other Fees	8.35%	27.266	27.037	26.729	26.377	54.303	53.106	70.32%
5	Lodging Facility Use Tax	3.64%	11.901	12.441	13.005	13.595	24.342	26.600	74.30%
6	Resource Indemnity Tax	0.67%	2.201	1.080	1.055	1.062	3.281	2.117	74.62%
7	Arts Trust Interest	0.09%	0.305	0.314	0.322	0.337	0.619	0.659	74.72%
8	Capital Land Grant Interest and Income	0.34%	1.101	0.827	0.822	0.613	1.928	1.435	74.94%
9	Deaf & Blind Interest and Income	0.09%	0.284	0.292	0.295	0.298	0.576	0.593	75.02%
10	Parks Trust Interest	0.34%	1.106	1.114	1.127	1.153	2.220	2.280	75.37%
11	Pine Hills Interest and Income	0.11%	0.355	0.348	0.358	0.363	0.703	0.721	75.47%
12	RIT Trust Interest	2.24%	7.321	7.376	7.377	7.379	14.697	14.756	77.69%
13	TSE Trust Interest	2.08%	6.805	7.201	7.871	8.472	14.006	16.343	80.14%
14	Property Tax: 6 Mill	3.61%	11.806	11.627	11.989	12.292	23.433	24.281	83.78%
15	Property Tax: 9 Mill	0.09%	0.286	0.000	0.000	0.000	0.286	0.000	83.78%
16	Tobacco Trust Interest	0.30%	0.968	1.741	2.464	3.253	2.709	5.717	84.64%
17	Regional Water Trust Interest	0.20%	0.643	1.151	1.404	1.670	1.794	3.074	85.10%
18	Common School Interest and Income	15.57%	50.875	51.175	49.745	49.631	102.050	99.376	100.00%
	Total Non-General Fund	100.00%	$326.689	$328.933	$331.564	$335.292	$655.622	$666.856	100.00%

It should be noted that the RTIC discussed the two issues shown in Figure 8. By their formal actions, the committee did not include any of these potential revenues in the revenue estimate for the 2005 biennium. These issues were discussed, but the committee did not believe they had sufficient information to include them in the 2005 biennium revenue estimates. Since further information would be available after the convening of the 58th Legislature, the committee deferred any action on these issues to the House Taxation Committee.

Figure 8
Significant Revenue Issues
Action By Revenue and Transportation Interim Committee
In Millions

Revenue Issue	RTIC Action	Potential Revenue Impact 2003,2004,2005
Property Reappraisal Impacts	Did Not Include	$9.815
Consumer Protection Litigation	Did Not Include	5.500
Total		**$15.315**

2005 BIENNIUM PROJECTION

Figure 9 shows the projected present law general fund balance for the 2005 biennium. Amounts shown include the revenue estimates as adopted by RTIC on November 19, 2002, and the cost of operating state government based on present law requirements. These disbursement amounts are as proposed in the Executive Budget. However, any present law adjustments that reduced services were categorized as a new proposal. These negative present law adjustments have been combined with all other new proposals and are shown in Figure 11. The present law amounts shown for both anticipated revenues and expenditures do not include any positive new proposals or initiatives recommended by the executive.

Figure 9
2005 Biennium General Fund Balance
Present Law Only
In Millions

	Estimated 2005 Biennium
Beginning Fund Balance	**$4.357**
Revenues	
Current Law Revenue	2,526.709
Total Funds Available	**$2,531.066**
Disbursements	
General Appropriations	
Human Services	583.665
Corrections	217.133
Higher Education	290.256
Public Schools	1,029.848
Other Government	293.699
Statutory Appropriations	268.118
Non-Budgeted Transfers	31.780
Feed Bill Appropriations	6.699
Anticipated Reversions	(8.191)
Total Disbursements	**$2,713.007**
Ending Fund Balance Before Reserve	**($181.941)**
Proposed Executive Budget Reserve	**($50.060)**
Projected Present Law Deficit	**($232.001)**

LFD COMMENT Present law is defined in statute as "that level of funding needed under present law to maintain operations and services at the level authorized by the previous legislature." The concept of present law versus new proposals allows the legislature to examine requested adjustments from a perspective of a "necessary" change to a "desired" change. This distinction assists the legislature in formulating a budget that focuses on existing services before any new initiatives or programs are considered.

LFD ISSUE Although the executive is requesting supplemental appropriations of $15.7 million for fiscal 2003, their fund balance statement for the 2005 biennium does not include any anticipated supplemental or emergency appropriations. Supplemental appropriations have never been less than $11.5 million for the last 7 biennia and have never been included in the balanced budget plan.

As Figure 9 shows, the 2005 biennium ending general fund balance is projected to be a negative $232 million before any new proposals or initiatives are considered. This balance indicates the state cannot maintain the existing level of services without a reduction in services, revenue enhancements, or a combination of both.

Figure 10 shows the allocation of general fund dollars to functional areas provided the funds were available to fund present law costs. As the chart indicates, educational services consume almost 49 percent of total general fund expenditures, with human service and correctional services expending nearly 30 percent. All other governmental agencies expend almost 11 percent, with the remaining 11 percent expended by statutory appropriations for debt service, retirement systems, and local government reimbursements. For more information on statutory appropriations and non-budgeted transfers, see page 129.

Figure 10
2005 Biennium Total General Fund Present Law

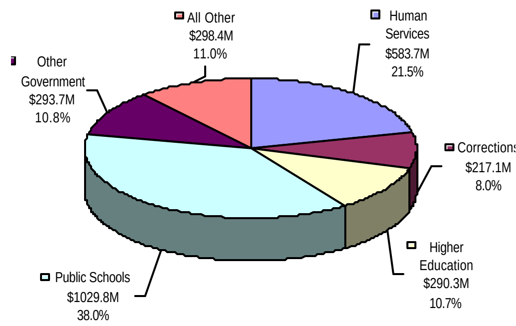


Figure 11 shows the projected general fund balance with the executive new proposals and initiatives included. The executive new proposals are categorized as either a revenue or disbursement proposal. Since the present law budget is negative, the total budget solution for all of the executive new proposals is $218.0 million. This amount, combined with the available present law balance, results in an ending balance of $36.0 million or $14 million less than the executive's recommended ending fund balance reserve of $50.1 million.

Figure 11
2005 Biennium General Fund Balance
With Executive New Proposals
In Millions

	Estimated Fiscal 2004	Estimated Fiscal 2005	Estimated 2005 Biennium
Beginning Present Law Balance	**($181.941)**	**($66.864)**	**($181.941)**
Executive Revenue Proposals			
State Fund Transfer	13.480	3.780	17.260
Extend Coal, Oil&Gas, Metal Reallocation	4.250	4.000	8.250
Oil and Gas Accrual	3.000		3.000
Terminate Infrastructure Credit	2.000		2.000
Permanent Coal Trust Transfer	93.000	(6.720)	86.280
Coal Tax Trust Reallocation	(0.130)	(0.390)	(0.520)
Reduced Revenue Due Expenditure Proposals	(0.531)	(0.378)	(0.909)
Total Revenue Proposals	**$115.069**	**$0.292**	**$115.361**
Executive Disbursement Proposals			
General Appropriations			
Human Services	(25.343)	(27.118)	(52.461)
Corrections	(5.217)	(2.058)	(7.275)
Higher Education	(7.925)	(8.957)	(16.882)
Public Schools	(9.635)	2.810	(6.825)
Other Government	(6.588)	(8.427)	(15.015)
Cultural and Aesthetic Grants	0.250	0.250	0.500
Department of Transportation Transfers	(2.960)	(3.010)	(5.970)
Research & Commercial, Growth Agriculture	(4.190)	(4.190)	(8.380)
Executive Pay Proposal	3.740	5.940	9.680
Total Disbursement Proposals	**($57.868)**	**($44.760)**	**($102.628)**
Total Executive New Proposals	**$172.937**	**$45.052**	**$217.989**
Ending Balance Before Reserve	($9.004)	($21.812)	$36.048
Executive Proposed Ending Fund Reserve	57.860	50.060	50.060
Difference From Proposed Reserve	**($66.864)**	**($71.872)**	**($14.012)**

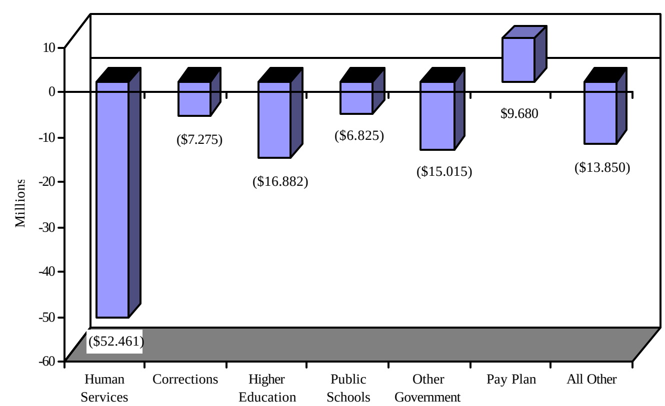
LFD ISSUE

The Executive Budget includes several temporary and phased-in proposals that impact the 2007 biennium budget. This is because the temporary revenue initiatives will not be available next biennium, while the phased-in disbursements will cost significantly more in future biennia. This means the 2005 legislature will be faced with funding additional services above the 2005 biennium costs. A biennium budget should not be developed with significant cost increases in the second year of the biennium without a corresponding revenue adjustment.

Figure 12 shows the allocation of all new proposal expenditure reductions to functional areas. As the chart depicts, the Executive Budget allocates the largest dollar reductions to human services, higher education, and other governmental agencies. Corrections and public school funding are recommended for the least reduction when compared to the other three areas.

The new proposal recommendations of the executive include both revenue and disbursement types. Figure 13 on the next page, graphically portrays the dollar impact of these proposals. As shown in the chart, disbursement and revenue initiatives are approximately equal for a combined solution of $218.0 million. When this amount is combined with the present law deficit of $232 million, the Executive Budget (if adopted) would create a general fund balance of $36.0 million or $14.0 million below their recommended reserve.

Figure 12
2005 Biennium Total General Fund New Proposals



DIFFERENCES FROM EXECUTIVE PROPOSAL

The Executive Budget as submitted projects an ending fund balance of $50.1 million after funding all executive present law adjustments and new proposals. This contrasts with Figure 11, which shows a general fund balance of $36.0 million, or a difference of $14.0 million. This balance is based on the RTIC revenue estimates, LFD estimates for statutory appropriations and reversions, and the executive's recommendations for all present law adjustments and new proposals. As advocated by the LFD in the past, an adequate reserve is necessary for unexpected occurrences including emergencies, fire suppression costs, supplemental appropriations, or lower than expected revenue collections.

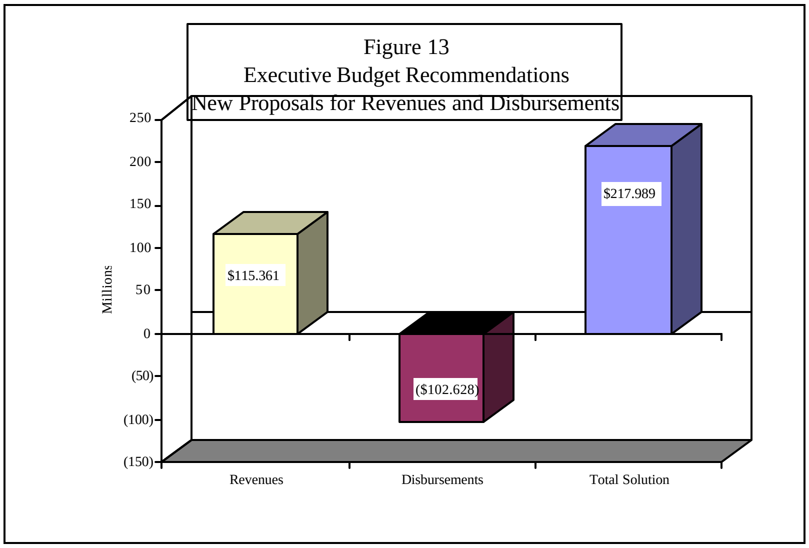


Figure 13
Executive Budget Recommendations
New Proposals for Revenues and Disbursements

LFD ISSUE The executive general fund budget for the 2005 biennium is over $2.6 billion. The recommended ending fund reserve is $50.1 million, or approximately 1.9 percent of total disbursements. This balance is insufficient when the events of the current biennium are considered. The total revenue shortfall during fiscal 2002 ($64.8) million would deplete this balance in its entirety. The legislature may wish to consider whether this recommended reserve is sufficient to ensure budget stability and control of the budget decision-making process. A reserve of 3 to 5 percent is generally recommended by experts and is commonly practiced by other states. (see page 140, for more details)

As shown in Figure 14, there are a number of items that contribute to the total difference of $14.0 million. Each of these differences is explained in the next section.

Explanation of Differences

General Fund Revenue - The combined differences of all general fund sources between the RTIC adopted estimates and the executive are $9.7 million. This difference is primarily due to the committee's reluctance to include any impacts of property reappraisal and consumer litigation efforts.

General Appropriations/Miscellaneous Appropriations – The net difference between these appropriation items is $14.7 million. The executive included the 17-7-140, MCA spending reductions in the general appropriations category, while the LFD included these reductions in the anticipated reversion category.

Figure 14
Differences From Executive Budget
Fiscal 2003, 2004, 2005
In Millions

Fund Balance Category	3 Year Difference
Beginning Fund Balance	$0.018
Revenues	(9.702)
Disbursements	
General Appropriations	(14.730)
Statutory Appropriations	(4.058)
Non-Budgeted Transfers	0.116
Supplemental Appropriations	0.004
Anticipated Reversions	14.323
Total Differences	**($14.029)**

Statutory Appropriations – The difference in this category is due to the information received from agencies that administer statutory appropriations. In most instances, the executive and the LFD relied on information supplied by the respective agencies. Because the executive is required to submit the executive budget by November 15th, the LFD had more current information available.

Non Budgeted Transfers – The difference between this category is minimal.

Anticipated Reversions – The difference in this category is $14.3 million. The executive included the 17-7-140, MCA reductions in the general appropriations category while the LFD included these reductions in the anticipated reversion category.

Summary

In summary, if the RTIC revenue estimate recommendations were adopted by the legislature, the general fund present law balance would be a negative $232.0 million. A balance in the general fund of $36.0 million would occur if the legislature adopted the executive's recommendations for all new proposals and initiatives, $14.0 million below the executive recommended ending reserve. This would therefore require either a reduction in services provided via reduced expenditures, revenue enhancements, and/or a lower reserve below $50.1 million to eliminate the difference.

PROJECTED GENERAL FUND BALANCE

Figure 15 shows the detailed general fund balance sheet based on present law revenues and disbursements, followed by a sub-table that shows the balance when the executive's new proposals are included. The $50.1 million reserve as proposed by the executive is not shown in this table.

Figure 15
2005 Biennium General Fund Balance
Based on Present Law
In Millions

	Actual Fiscal 2002	Estimated Fiscal 2003	Estimated Fiscal 2004	Estimated Fiscal 2005	Estimated 2003 Biennium	Estimated 2005 Biennium
Beginning Fund Balance	**$172.897**	**$83.228**	**$4.357**	**($110.274)**	**$172.897**	**$4.357**
Revenues						
Current Law Revenue	1,265.713	1,208.408	1,235.776	1,290.933	2,474.121	2,526.709
Total Funds Available	**$1,438.610**	**$1,291.636**	**$1,240.133**	**$1,180.659**	**$2,647.018**	**$2,531.066**
Disbursements						
General Appropriations	1,120.576	1,058.569	1,206.820	1,207.779	2,179.145	2,414.599
Statutory Appropriations	149.108	125.950	133.219	134.899	275.058	268.118
Miscellaneous Appropriations	68.016	84.495			152.511	
Non-Budgeted Transfers	18.768	9.044	14.462	17.318	27.812	31.780
Continuing Appropriations	2.611	5.415			8.026	
Supplemental Appropriations		15.686			15.686	
Feed Bill Appropriations		8.622		6.699	8.622	6.699
Anticipated Reversions	(3.176)	(20.502)	(4.094)	(4.097)	(23.678)	(8.191)
Total Disbursements	**$1,355.903**	**$1,287.279**	**$1,350.407**	**$1,362.598**	**$2,643.182**	**$2,713.005**
Adjustments	0.521				0.521	
Reserved Ending Fund Balance	**$83.228**	**$4.357**	**($110.274)**	**($181.939)**	**$4.357**	**($181.939)**
Unreserved Ending Fund Balance	**$83.228**	**$4.357**	**($110.274)**	**($181.939)**	**$4.357**	**($181.939)**
Net Operations	**($90.190)**	**($78.871)**	**($114.631)**	**($71.665)**	**($169.061)**	**($186.296)**

New Executive Proposals Not Included Above						
Revenue Inititative			$115.069	$0.292		$115.361
Disbursement New Proposals						
Present Law Reductions			16.229	17.496		33.725
New Proposal Increase			(8.834)	(13.339)		(22.173)
New Proposal Decrease			47.314	39.593		86.907
Other Proposals			3.160	1.010		4.170
Total Disbursement Inititative			57.869	44.760		102.629
Potential Ending Fund Balance Without Reserve			**$62.664**	**$36.051**	**$4.357**	**$36.051**