

LEGISLATIVE FISCAL DIVISION REVENUE ESTIMATES

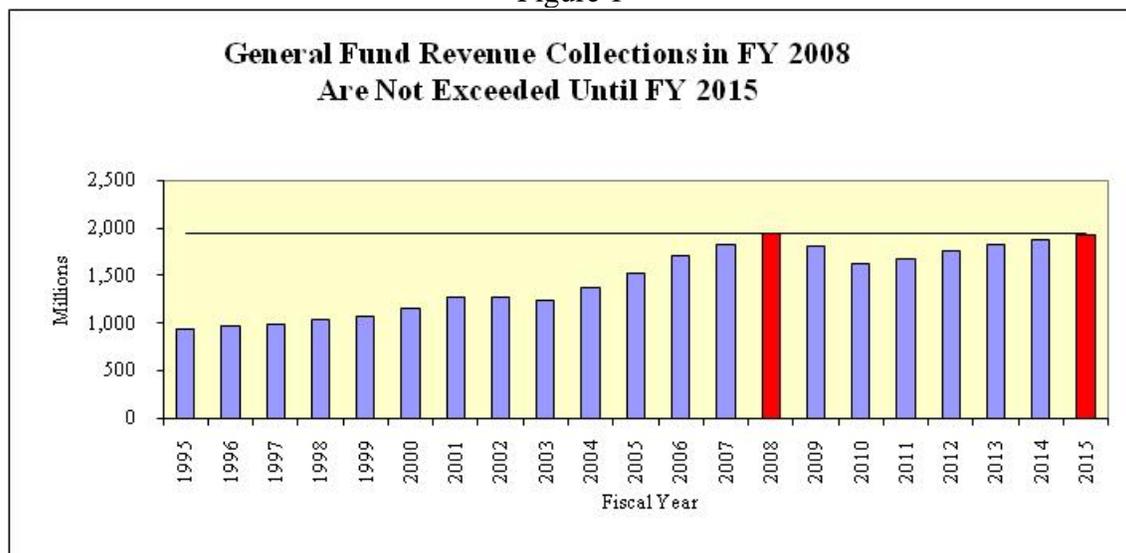
INTRODUCTION TO ECONOMIC CONDITIONS

The general outlook for the US and Montana’s economy for the next three years is for a slow gradual recovery from the “Great Recession”. Although Montana’s economy is affected by commodity prices for oil, natural gas, coal, metals, and agricultural products, many other economic factors are affected by national conditions beyond the state’s control. Interest rates, global commodity demand, equity gains and losses, 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 “drivers” are used to forecast revenue for the fiscal period 2011 – 2013.

The Legislative Fiscal Division (LFD) receives the services of two economic forecasting companies – IHS Global Insight and Moody’s Analytics (MA). Both firms provide national and state specific economic forecasts for a variety of economic variables for both a short and long term perspective. In general, both companies are forecasting a slow, gradual economic recovery for the US economy with a low probability of a secondary recession. MA, however, is more bullish about Montana’s economy and is expecting stronger growth beginning in calendar 2012. Review of their underlying assumptions for Montana does not seem to support their growth outlook and is not consistent with the forecasts of the Bureau of Business and Economic Research of Missoula. Because of this, the “baseline” forecast of IHS was used throughout to derive the LFD recommendations.

Actual revenue collections for FY 2009 and 2010 declined from their peak levels reached in FY 2008 and are not expected to reach that level again until FY 2015 (Figure 1). Estimated receipts beginning in FY 2011, however, are expected to show signs of recovery but at a slow modest rate. If a “double dip” recession occurs, the revenue outlook would be worse but would depend on the length and severity of the second recession. The economic conditions during the last two years have changed rapidly as significant issues have unfolded during this time.

Figure 1

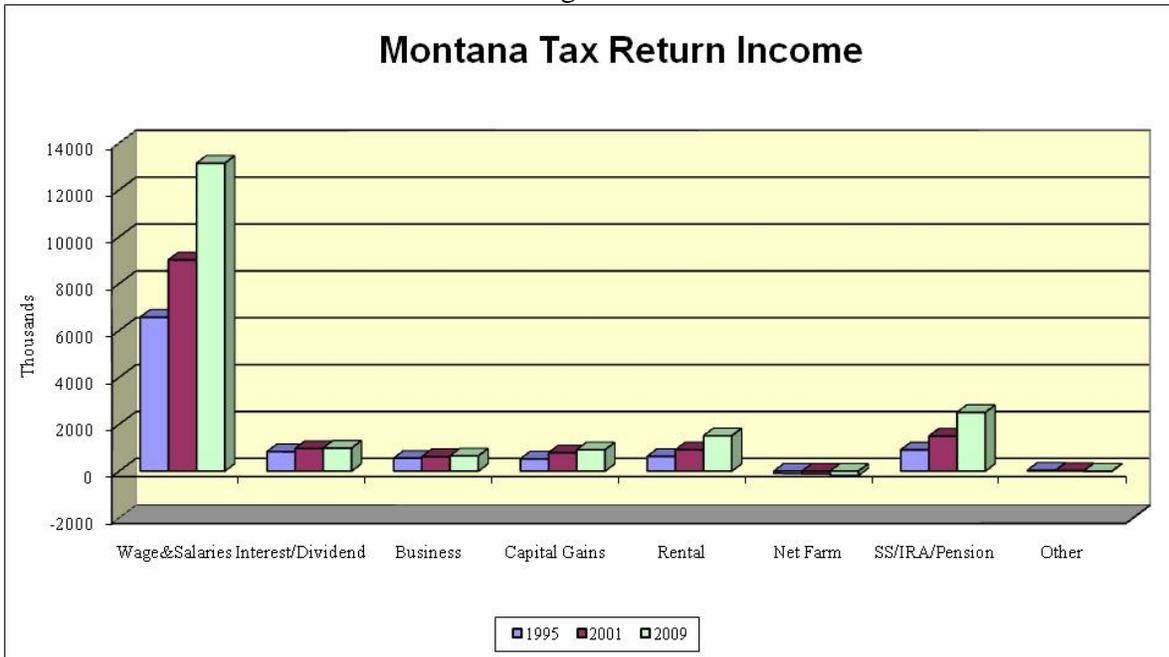


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KEY RISKS TO ECONOMIC ASSUMPTIONS

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. Figure 2 shows the importance of wage and salary income compared to the other components of income.

Figure 2



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.

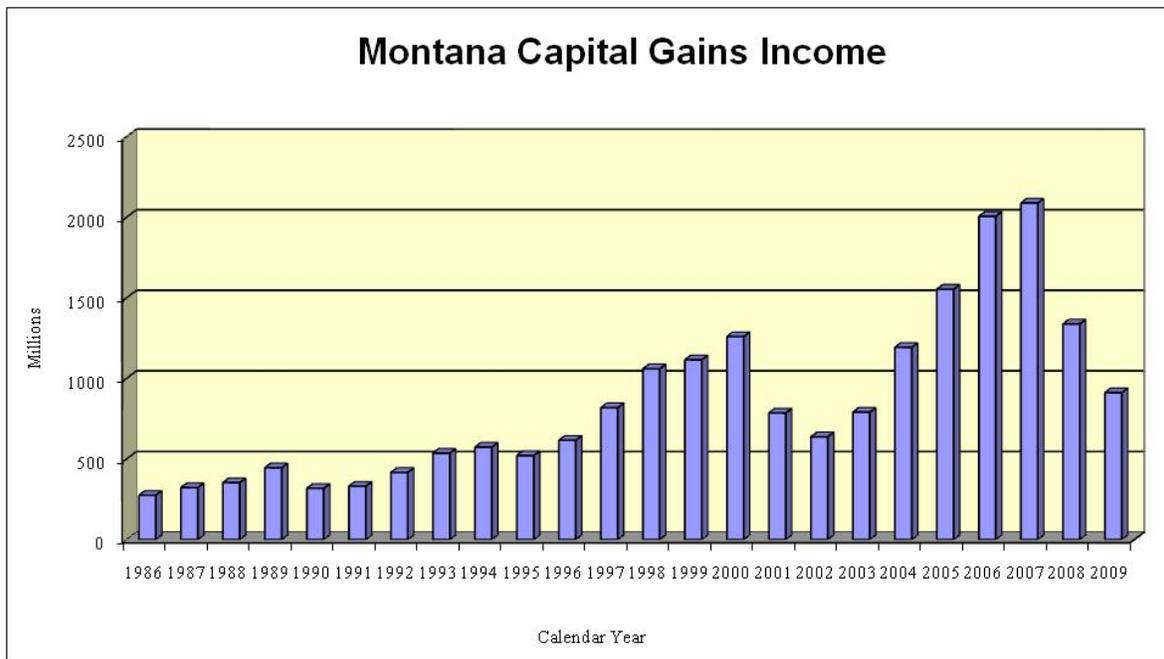
Corporate Profits - In light of the “Great Recession”, a significant risk is the impact of the net operating loss (NOL) carry back provisions provided in 15-31-119, MCA. A NOL generally occurs when deductions exceed gross income. If for any taxable period a net operating loss is sustained, the loss must first be accounted for as a carry back to each of the three taxable periods 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 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.

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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. Figure 3 shows the history of capital gains income since 1986.

Figure 3



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 Bush

Repeal of Bush 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

Figure 4

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 a continuation of the Bush tax reductions. Figure 4 shows the impact on state general fund revenues if the Bush tax reductions are not extended.

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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 by 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.

KEY REVENUE CATEGORIES

Figure 5

Major General Fund Revenue Sources			
Category	Actual FY 2010	% of Total	Cumulative Percent
1 Individual Income Tax	717,834,371	44.12%	44.12%
2 Property Tax	222,509,767	13.67%	57.79%
3 Vehicle Fees/Taxes	103,861,549	6.38%	64.17%
4 Oil & Gas Production Tax	95,490,812	5.87%	70.04%
5 Corporation Income Tax	87,900,911	5.40%	75.44%
6 Video Gaming Tax	52,395,999	3.22%	78.66%
Remaining Sources	<u>347,151,129</u>	21.33%	99.99%
Total	\$1,627,144,538		

As shown in the Figure 5, individual income tax is the largest general fund revenue source followed by property tax, vehicle fees/taxes, oil and gas production tax, corporation income tax, and video gaming tax. Combined, these top six sources contributed almost 79 percent to total general fund revenues in FY 2010. When these sources are compared to the estimates establish by the 61st Legislature, the only source of revenue that exceeded the HJ 2 revenue estimate was oil and gas production tax. The economic conditions discussed above affect the

anticipated revenues from these key sources.

Individual Income Tax – Individual income tax revenues are expected to increase throughout the forecast period but a slow gradually increasing rate. This forecast is based on a slow economic recovery with no major disruption in the equity markets and no “double dip” recession. Further erosion in employment levels could reduce the forecast.

Property Tax – Property taxes are expected to show modest growth throughout the forecast period. Since reappraisal is now complete, the probability of any significant changes in statewide property values (other than the affects of reappraisal) is limited. This revenue source should be relative stable throughout the forecast period with some anticipated growth.

Vehicle Fees/Taxes - Vehicle fees and taxes is another source of revenue that is relatively stable when compared to the income tax sources. Since a large portion of this revenue is based on the number and age of vehicles, the variation in the anticipated revenue amounts would be due to a change in vehicle counts and age distribution of the vehicles. The probability of a significant change in vehicle counts is low. The distribution of the age of vehicles, however, could potential reduce anticipated revenue. It is assumed that the count and age distribution will not change materially during the forecast period.

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Oil & Gas Production Tax – Oil and gas production tax collections could be quite volatile if there is a major disruption in supply and a significant downturn in global demand. It is expected that this will not occur and that prices will generally grow at an inflationary amount. Production is expected to decline as the amount of barrels produced from the Bakken formation declines. If there is renewed interest in the Bakken fields in Montana, then revenues from this source could exceed current expectations.

Corporation Income Tax – Corporation income tax is a volatile source because of the profitability of state and national corporations and the net operating loss carry back provisions in Montana law. If corporations continue to experience operating losses, then the outlook for corporation income taxes would be extremely bleak. The current estimates assume corporations will return to a positive profit margin throughout the forecast period. Like individual income tax, a “double dip” recession would change this outlook considerably.

Video Gaming Tax – Video gaming tax declined in FY 2010 due to the “Great Recession” and the implementation of the smoking ban. Current data suggests that the impacts have not subsided and that revenues will increase but from a much lower base. If the economy recovers quicker and/or the smoking negative impacts subside, then revenues could be higher throughout the forecast period. Neither of these conditions are expected to occur.

Remaining Sources – Generally all the remaining sources are expected to be stable when looked at from an aggregate vantage point. Some of the smaller sources are expected to decline while others are expected to increase. Overall, no material change is expected for this aggregate category.

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REVENUE SUMMARY

Figure 6 compares the LFD general fund revenue estimates prepared in February with the revised estimates to be presented to the Revenue and Transportation Committee on Friday. For the 2013 biennium, the revised estimates are \$4.1 million higher than the estimates prepared in February. As shown in Figure 6, there are significant differences by category but in aggregate the 2013 biennium estimates have not changed materially. Figure 7 shows the revised estimates by the individual general fund revenue categories for FY 2011, 2012, and 2013..

Figure 6

General Fund Revenue Estimate Comparisons							
LFD Big Picture Estimates versus Revised Estimates (Millions)							
					Big Picture	LFD Rev.	
	Big Picture Estimate		LFD Rev. Estimate		Estimate	Estimate	
Revenue Category	FY 2012	FY 2013	FY 2012	FY 2013	2013 Biennium	2013 Biennium	Change
Individual Income Tax	801.321	854.057	781.891	825.590	1,655.378	1,607.481	(47.897)
Property Tax	239.082	243.529	237.809	242.859	482.611	480.668	(1.943)
Corporation Income Tax	79.868	91.106	123.315	128.179	170.974	251.494	80.520
Vehicle Taxes and Fees	103.778	104.714	106.615	106.999	208.492	213.614	5.122
Oil and Gas Production Tax	95.174	91.840	101.803	100.119	187.014	201.922	14.908
Video Gaming Tax	64.335	67.772	57.562	60.199	132.107	117.761	(14.346)
Insurance Premiums Tax	59.276	60.854	57.500	60.789	120.130	118.289	(1.841)
Treasury Cash Interest	20.147	25.712	6.173	17.398	45.859	23.571	(22.288)
All Other Categories	<u>281.928</u>	<u>287.055</u>	<u>279.989</u>	<u>280.825</u>	<u>568.983</u>	<u>560.814</u>	<u>(8.169)</u>
Totals	\$1,744.909	\$1,826.639	\$1,752.657	\$1,822.957	\$3,571.548	\$3,575.614	\$4.066

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Figure 7

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	44.96%
2	Property Tax	13.67%	222.510	229.084	237.809	242.859	451.594	480.668	58.40%
3	Corporation Income Tax	5.40%	87.901	103.320	123.315	128.179	191.221	251.494	65.43%
4	Vehicle Tax	5.50%	89.485	92.210	91.857	92.188	181.695	184.045	70.58%
5	Common School Interest and Income	0.00%	-	-	-	-	-	-	70.58%
6	Insurance Tax & License Fees	3.37%	54.892	54.587	57.500	60.789	109.480	118.289	73.89%
7	Coal Trust Interest	1.65%	26.914	26.512	27.065	27.418	53.426	54.483	75.41%
8	US Mineral Royalty	1.86%	30.288	29.674	29.714	27.188	59.962	56.902	77.00%
9	All Other Revenue	2.17%	35.360	28.883	27.394	27.880	64.243	55.274	78.55%
10	Tobacco Settlement	0.21%	3.469	3.565	3.564	3.559	7.034	7.123	78.75%
11	Telecommunications Excise Tax	1.45%	23.523	21.772	21.759	21.887	45.295	43.646	79.97%
12	Video Gambling Tax	3.22%	52.396	55.340	57.562	60.199	107.736	117.761	83.26%
13	Treasury Cash Account Interest	0.17%	2.692	1.666	6.173	17.398	4.358	23.571	83.92%
14	Estate Tax	0.01%	0.091	0.005	-	-	0.096	-	83.92%
15	Oil & Natural Gas Production Tax	5.87%	95.491	101.421	101.803	100.119	196.912	201.923	89.57%
16	Motor Vehicle Fee	0.88%	14.377	14.815	14.758	14.811	29.192	29.569	90.40%
17	Public Institution Reimbursements	1.35%	22.000	17.555	17.172	17.374	39.555	34.546	91.36%
18	Lodging Facility Use Tax	0.76%	12.331	12.852	13.515	14.014	25.183	27.529	92.13%
19	Coal Severance Tax	0.63%	10.322	13.594	12.032	12.266	23.916	24.298	92.81%
20	Liquor Excise & License Tax	0.96%	15.626	16.258	16.936	17.652	31.884	34.588	93.78%
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	97.61%
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%	<u>\$1,627.145</u>	<u>\$1,671.033</u>	<u>\$1,752.657</u>	<u>\$1,822.957</u>	<u>\$3,298.177</u>	<u>\$3,575.615</u>	100.00%