

ECONOMIC OVERVIEW

Introduction

The state budget is affected by state, national, and world economic conditions. The demand for public services is affected by population growth and how the state's residents are faring economically. The cost of providing public services is affected by general inflation and the costs of specific government purchases, such as utilities. The revenue state government has to pay for public services depend on taxpayers' incomes, property values, and business activity.

The executive budget is based on assumptions about economic conditions through the 2009 biennium. This section describes the key economic assumptions that are common to all of the revenue estimates. It also provides some background by describing long-term trends in the state economy. The sections describing individual revenue estimates explain how each revenue source is related to economic conditions and explain any assumptions that are unique to specific revenue sources.

National Economic Conditions

The national economy went through a mild recession in 2000 and 2001. The economy began to recover in 2002 as growth of gross domestic product (GDP) accelerated. GDP growth reached 3.9% in 2004 and moderated to 3.2% in 2005. GDP growth is forecast to be 2.36% in 2007, 3.30% in 2008, and 3.33% in 2009. National employment declined from the second quarter of 2001 through the third quarter of 2003. National employment rebounded growing at 1.1% in 2004, 1.5% in 2005, and is forecast to grow 1.4% by the end of 2006. National employment growth is forecast to be 1.1% in 2007, 1.4% in 2008, and 1.6% in 2009. Inflation peaked at 2.9% in 2005 and at the end of 2006 it is forecast to be 2.8%. Inflation is expected to be approximately 2% for 2007 through 2009.

Montana Production and Income

Table 1 shows Montana's actual gross state product (GSP) and personal income from 1996 through 2005 and Global Insight's forecasts for 2006 through 2009.

In 2000 and 2001, GSP grew rapidly as the national economy went into a recession. GSP grew more slowly in 2002, but accelerated in 2003. In 2004 and 2005, GSP grew 8.26% and 8.36% respectively, much faster than in any recent year. In 2006, GSP has remained quite high. However, Global Insight forecasts GSP growth to moderate for 2007 through 2009.

Personal income in Montana grew rapidly in 2000 and 2001. This growth was due to a combination of increasing economic activity in the state, as reflected in GSP growth, and gains from the stock market boom. Personal income grew by only 2.06% in 2002, but rebounded in 2003, growing 5.50%. In 2004 and 2005 personal income growth grew rapidly at 6.63% and 5.36%, respectively. Personal income growth in 2006, at 7.66%, is higher than it has been since 1996. Global Insight forecasts personal income growth to moderate for 2007 through 2009.

Table 1
Gross State Product and Personal Income
1996 through 2009
(\$ million)

Year	Gross State Product	% Change	Personal Income	% Change
1996	18,425	3.31%	16,880	4.95%
1997	19,141	3.88%	17,688	4.79%
1998	19,884	3.88%	18,857	6.60%
1999	20,408	2.64%	19,373	2.74%
2000	21,366	4.69%	20,716	6.94%
2001	22,473	5.18%	22,359	7.93%
2002	23,564	4.85%	22,819	2.06%
2003	25,476	8.11%	24,073	5.50%
2004	27,581	8.26%	25,670	6.63%
2005	29,886	8.36%	27,046	5.36%
2006	32,094	7.39%	29,118	7.66%
2007	33,790	5.29%	30,856	5.97%
2008	35,598	5.35%	32,571	5.56%
2009	37,414	5.10%	34,399	5.61%

Montana Employment and Population

Table 2 shows Montana actual non-farm employment and population for 1996 through 2005 and Global Insight's forecasts through 2009.

Table 2
Montana Employment and Population
1996 through 2009

Year	Employment	% Change	Population	% Change
1996	360.308	2.73%	886.321	1.02%
1997	364.892	1.27%	890.120	0.43%
1998	373.083	2.24%	893.221	0.35%
1999	380.308	1.94%	898.361	0.58%
2000	387.575	1.91%	903.666	0.59%
2001	391.683	1.06%	906.741	0.34%
2002	395.983	1.10%	911.527	0.53%
2003	400.692	1.19%	919.105	0.83%
2004	411.250	2.64%	927.989	0.97%
2005	420.492	2.25%	936.564	0.92%
2006	432.249	2.80%	943.026	0.69%
2007	441.363	2.11%	947.760	0.50%
2008	447.376	1.36%	952.345	0.48%
2009	453.606	1.39%	956.885	0.48%

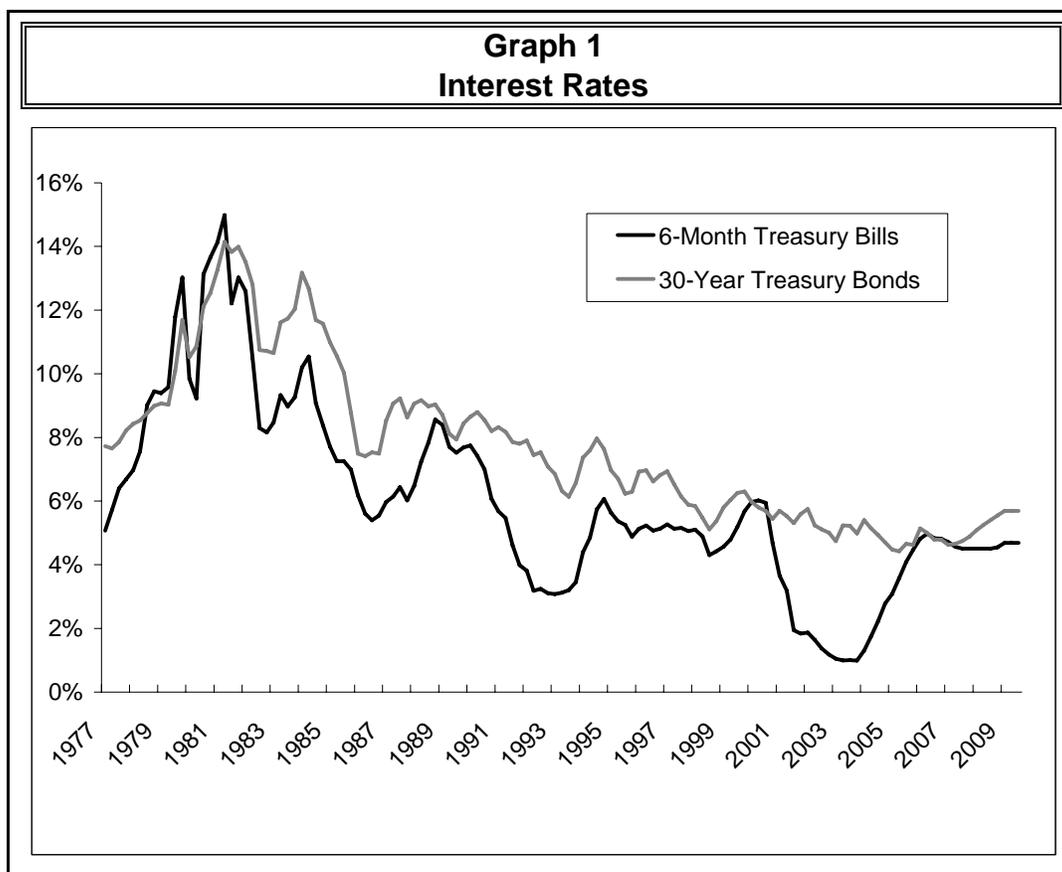
The recession negatively impacted Montana's labor market in 2001 as growth in non-farm employment decreased from 1.91% to 1.06%. In 2003, employment rebounded slightly and in 2004, non-farm employment grew by an eight-year high of 2.64%. Growth is forecast to be 2.80% at the end of 2006, and is forecast to remain above 2.00% in 2007. Growth is forecast to eventually moderate at about 1.4% in 2008 and 2009.

In the second half of the 1990s and early 2000s, Montana's population grew at about one-half of a percent per year. Population growth accelerated in 2003 through 2005 and leveled off in 2006. Global Insight forecasts population to increase at 0.5% for 2007 through 2008.

Interest Rates

The state earns interest on trust funds, such as the coal severance tax trust fund, the school trust, and the tobacco settlement trust, and on short-term cash holdings in the general fund and other state funds. The state also pays interest on funds it borrows. Trust fund interest earnings and payments on new long-term debt are affected by changes in long-term interest rates. Most bonds held by the state trust funds are kept for several years; consequently, trust fund interest earnings are affected more by long-term trends than year-to-year variations. On the other hand, interest earnings on cash balances and interest payments on short-term debt are affected by changes in short term interest rates as well as long-term trends.

Figure 1 shows interest rates on 6-month and 30-year U.S. Treasury obligations from 1977 through the third quarter of 2006 and Global Insight's forecasts through 2009.



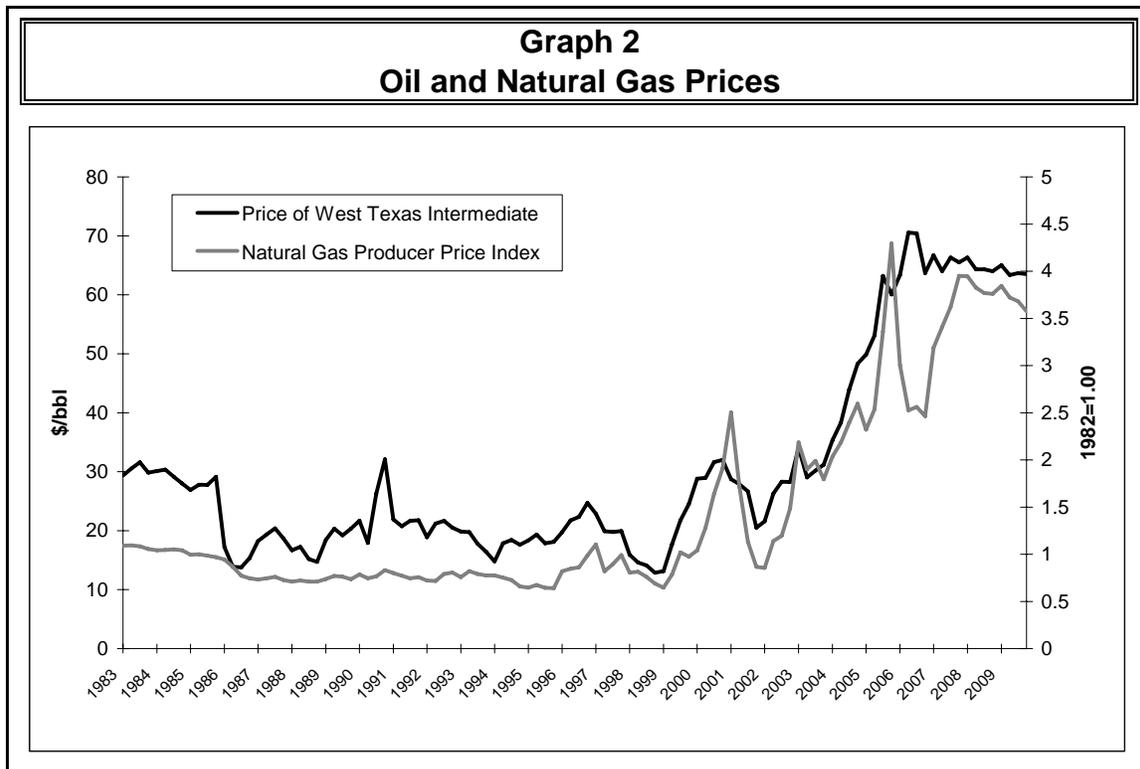
Interest rates hit historic highs in 1981, with both short-term and long-term interest rates at over 14%. Interest rates have varied over the course of business cycles, but generally decreased from 1981 through 2003. Short-term interest rates are more volatile than long term rates. Short term rates fall when the Federal Reserve, attempting to stimulate the economy, decreases the federal funds rate (the rate it charges banks). When the Federal Reserve endeavors to control inflation by increasing the federal funds rate, short-term interest rates rise.

Short-term interest rates hit all-time lows early in 2004. Interest rates began rising in the second quarter of 2004 and continued to rise through the first half of 2006. Interest rates are forecast to slowly decline through 2007 then increase in 2008 and 2009.

Oil and Natural Gas Prices

Oil and natural gas prices affect the state budget in several specific ways. The state taxes oil and natural gas production, receiving royalties from production on state lands and a share of the royalties from production on federal land located in the state. State government also buys gasoline and diesel fuel for state vehicles and natural gas for state buildings. Energy prices also affect the state economy in general, with higher prices translating into higher incomes for the energy producing sector and higher costs for the rest of the economy.

Figure 2 shows national oil and natural gas prices from 1983 through the third quarter of 2006 and Global Insight's forecasts through 2009. It shows the price of the standard grade of crude oil, West Texas Intermediate, measured on the left axis and a price index for natural gas, with the average price in 1982 scaled to 1.00, on the right axis.



Oil prices are quite volatile. Natural gas prices have become more volatile since 1995. Energy consumption is relatively insensitive to prices in the short-run. As a result, short-run changes in supplies can produce large price swings. In the long-run, energy users respond to higher prices by conserving and using energy more efficiently. Oil and

gas producers respond to sustained higher prices by increasing exploration and development activities which increase supplies.

From about 1987 through 1999, oil and natural gas prices were relatively low as world supplies were plentiful. However, for several reasons, oil and natural gas prices have risen significantly since 1999. First, world supplies have been stagnant. Oil and gas fields developed in the 1970s are being depleted and relatively low oil prices have limited further exploration. Second, world demand has steadily grown as higher incomes in developing countries, particularly China, have enabled consumers to afford cars, appliances, and other energy using consumer goods. Third, short-term supply disruptions such as scares due to war, political instability in producing regions, and hurricane damage have led to short-term price spikes.

Both oil and natural gas prices peaked in the second quarter of 2006 and thereafter dropped. Oil is forecast to remain at approximately \$65 per barrel through 2009. However, natural gas prices are expected to rebound to in 2007 and remain above a price index value of 3.6.

Property Values

Property tax is the largest revenue source in Montana. State and local governments, school districts, and special improvement districts collect over \$1 billion in property taxes and related fees each year. Property taxes depend on mill levies, property tax rates (the ratio of taxable value to market value), and property values.

In the ten-year period from calendar year 1995 (FY 1996) to calendar year 2005 (FY 2006), the statewide average mill levy increased 48.6%. Mill levies vary dramatically between different cities and different counties. For example, county mill levies ranged from 218.57 mills in Rosebud County to 690.36 mills in Silver Bow County in 2006. These variances result in the individual properties having considerable differences in their property tax bill for comparably valued property.

Past legislation reduced tax rates for most classes of property. As tax rates decline and more property is exempted, the amount of property tax that must be raised from the remaining property tax owners increases. Table 3 shows statewide taxable values for calendar year 1998 and calendar year 2006, the percent of total taxable value in each property class, and the percent change in taxable value for each class.

Total taxable value increased 0.4% from tax year 1998 to tax year 2006. This is primarily attributable to legislation that reduced the tax rates on specific property classes and exempted some types of property from taxation. Total statewide taxable value is forecast to increase in 2007 and 2008. All the forecast increase is due to new property in class 4 residential and commercial real property, class 8 business equipment, and class 9 pipelines and electric transmission. The taxable values of other classes of property are forecast to decline or remain the same.

Table 3
Property Taxable Values Calendar Year 1998 and 2006
Change in Share of Property Tax Base

Tax Class Description	Calendar Year 1998			Calendar Year 2006			% Change Taxable Value
	Tax Rate	Taxable Value	% of Base	Tax Rate	Taxable Value	% of Base	
1 Mine Net Proceeds	100.000%	7,625,083	0.4%	100.000%	3,252,295	0.2%	-57.3%
2 Gross Proceeds Metal Mines	3.000%	8,780,907	0.5%	3.000%	21,106,138	1.1%	140.4%
3 Agricultural Land	3.816%	143,007,340	7.4%	3.300%	141,002,419	7.2%	-1.4%
4 Res Residential Real Property	3.816%	704,132,657	36.3%	3.300%	876,260,627	44.9%	24.4%
4 Com Commercial Real Property	3.816%	247,920,400	12.8%	3.300%	307,560,366	15.8%	24.1%
Sub 4 Subtotal Class 4	3.816%	952,053,057	49.0%	3.300%	1,183,820,993	60.7%	24.3%
5 Pollution Control Equipment	3.000%	34,074,765	1.8%	3.000%	35,077,724	1.8%	2.9%
6 Livestock	4.000%	23,833,179	1.2%	0.000%	-	-	-
7 Non-Centrally Assessed Utilities	8.000%	1,783,935	0.1%	8.000%	1,068,358	0.1%	-40.1%
8 Business Personal Property	6.000%	203,383,266	10.5%	3.000%	135,612,793	7.0%	-33.3%
10 Forest Land	0.790%	7,677,880	0.4%	0.350%	6,815,519	0.3%	-11.2%
12 Railroad and Airline Property	6.170%	65,266,087	3.4%	3.810%	41,576,814	2.1%	-36.3%
9 & 13 Telecom. & Electric Property	12.000%	494,534,742	25.5%	12% & 6%	378,795,900	19.4%	-23.4%
14 Wind Power Generation	-	-	-	3.000%	2,555,683	0.1%	100.0%
Totals		1,942,020,241			1,950,684,636		0.4%

The class 4 property share of the tax base increased from 49% in 1998 to about 61% in 2006. The percent share of the tax base that is class 4 property is expected to gradually increase in the future. Under the current property tax structure, class 4 property pays the majority of any property tax increases. The taxable value of class 8 property taxable value declined from 1998 to 2006 as its respective tax rate was reduced from 6% to 3%. Class 14 wind power generation represents new class of property added in 2005.

Structural Trends

Montana's population and economy have undergone significant structural changes. The population has become older, the mix of industries has changed, and the mix of occupations has changed

Population

Table 4 shows the 1980, 1990, and 2000 census counts of Montana population grouped into ten-year age groups and the percent of the total population in each group. For 1990 and 2000, it also shows the ten-year survival percentage for the groups aged 10 and up. This is the ratio of the number of people in an age group to the number in the next lower age group ten years earlier. For the 80 and over age group, it is the ratio of people 80 and over to the number of people 70 or over ten years earlier. For the total population, it is the ratio of total population to the total ten years earlier.

**Table 4
Age Structure of Montana Population**

Age	1980 Census		1990 Census			2000 Census		
	Persons	%	Persons	%	10 yr survival	Persons	%	10 yr survival
0-9	125,315	15.9%	125,603	15.7%		115,931	12.8%	
10-19	136,959	17.3%	120,285	15.0%	96.0%	140,275	15.5%	111.7%
20-29	145,395	18.4%	104,491	13.0%	76.3%	110,151	12.2%	91.6%
30-39	111,036	14.0%	134,798	16.8%	92.7%	118,328	13.1%	113.2%
40-49	77,291	9.8%	104,085	13.0%	93.7%	149,050	16.5%	110.6%
50-59	74,029	9.4%	71,729	8.9%	92.8%	110,143	12.2%	105.8%
60-69	64,756	8.2%	66,959	8.3%	90.4%	70,912	7.8%	98.9%
70-79	37,348	4.7%	49,789	6.2%	76.9%	54,699	6.1%	81.7%
80+	18,263	2.3%	24,201	3.0%	43.5%	34,004	3.8%	46.0%
Total	790,391	100.0%	801,939	100.0%	101.5%	903,494	100.0%	112.7%

Aging Population

In 1980, the 20 to 29 age group was the largest. People in this age group were born between 1951 and 1960, the final years of the post-World War II baby boom and the years immediately after. People born between 1951 and 1960 were in the 30 to 39 age group in 1990 and the 40 to 49 age group in 2000, and make up the largest age group in those years as well.

In 1990 and 2000, the second largest age group was people born between 1981 and 1990, who were between 0 and 9 in 1990 and between 10 and 19 in 2000. This second peak in the age distribution is caused by the children of the baby boomers and is often called the baby boom echo.

As the baby boomers have aged and life expectancies have increased, the population as a whole has become older. As Table 5 shows, in 1980 34% of the population was 40 or over and 15% was 60 or over. In 1990, 40% of the population was 40 or over and 18% was 60 or over. By 2000, the percentage 40 or over had increased to 46% and the percentage 60 or over remained at 18%. This aging of the population mirrors the national trend and will continue. In 2010, the 40 or over age group is forecast to remain the largest with over 50% of the population; however, more baby boomers will move into the 60 or over age group.

**Table 5
Aging of Montana Population**

	1980 Census	1990 Census	2000 Census	2010 Forecast
Age 40 or Over	34.4%	39.5%	46.4%	50.2%
Age 60 or Over	15.2%	17.6%	17.7%	20.0%

Population Migration

The ten-year survival percentages, shown in Table 4, are impacted by population growth as well as migration into and out of the state. The numbers in the totals row on the bottom of the table show the change in total population from one census to the next. Montana had very little population growth from 1980 to 1990. Montana's population in 1990 was only 101.5% of the 1980 population. In 2000, Montana's population was 112.7% of what it had been in 1990. This 12.7% population growth is just slightly less than national population growth of 13.2%.

In a population with no one moving in or out, ten-year survival percentages reflect mortality. They are nearly 100% for the younger age groups and fall off rapidly after middle age. The 1990 survival percentages follow this pattern with one significant exception. The 20 to 29 age group's survival percentage is 76%. This shows that at least 20% of the 10 to 19 year olds who lived in Montana in 1980 had moved out of the state by 1990, when they were between 20 and 29 years old. Some people in this age group moved into the state, so the percentage that is left must be greater than 20%. For the other age groups, approximately all people moving into the state equaled those moving out of the state.

Population growth from 1990 to 2000 entailed a combination of an increase due to more births than deaths and net in-migration. Survival percentages are more than 100% for four age groups: 10 to 19, 30 to 39, 40 to 49, and 50 to 59. This indicates that more people in these age groups moved to the state than moved away. In the 1990s, people over 30 moved to the state and brought their children. In 2000, the survival percentage for the 20 to 29 age group is only 92%, indicating that more people in this age group moved away than moved into the state.

Economic Structure

Table 6 shows the Montana's GSP divided into eleven sectors. Actual GSP, divided by sector, is shown for 1992, 1996, 2000, and 2004, and forecast amounts are shown for 2008. The sectors are sorted by descending order of the output value in 1992. For sectors that have grown faster than the economy as a whole, the percent of total output has increased over time. For sectors that have not grown as fast as the economy, the percent has decreased.

Table 6
Montana Gross State Product

Economic Sector	1992		1996		2000		2004		2008	
	\$ Million	% of Total								
Services	3,178	20.6%	3,993	21.7%	4,991	23.4%	6,424	23.3%	8,528	24.0%
Finance, Insurance, & Real Estate	2,288	14.8%	2,782	15.1%	3,409	16.0%	4,487	15.1%	5,920	16.6%
Transp., Comm., & Util.	2,073	13.4%	2,301	12.5%	2,495	11.7%	3,031	10.0%	3,844	10.8%
State and Local Gov't, Schools	1,744	11.3%	2,115	11.5%	2,464	11.5%	3,037	11.8%	3,715	10.4%
Retail Trade	1,217	7.9%	1,488	8.1%	1,665	7.8%	2,105	10.2%	2,559	7.2%
Manufacturing	975	6.3%	1,110	6.0%	1,277	6.0%	1,321	6.3%	1,734	4.9%
Agriculture, Forestry, & Fishing	820	5.3%	959	5.2%	753	3.5%	1,331	2.5%	1,398	3.9%
Federal Government	668	4.3%	684	3.7%	856	4.0%	1,074	4.9%	1,285	3.6%
Wholesale Trade	914	5.9%	1,133	6.2%	1,230	5.8%	1,521	6.2%	1,898	5.3%
Mining	581	3.8%	633	3.4%	720	3.4%	1,073	3.1%	1,672	4.7%
Construction	721	4.7%	928	5.0%	1,190	5.6%	1,700	6.6%	2,455	6.9%
Military	281	1.8%	299	1.6%	316	1.5%	477	6.6%	589	1.7%
Total	15,460	100.0%	18,425	100.0%	21,366	100.0%	27,581	106.6%	35,598	100.0%

- Services and finance, insurance, and real estate are the two largest sectors, together accounting for 38% of the value of output in 2004. Both sectors have grown faster than the economy as a whole since 1992 and are forecast to continue this trend. These combined sectors are forecast to account for 41% of GSP in 2008.
- Construction and state and local government and schools have also grown as a percent of GSP through 2004. Local government and schools is forecast to decline as a percent of GSP in 2008 while construction is forecast to grow as a percent of GSP in 2008. These two sectors will, as a total, remain at the same percent of GSP as they were previously.
- Retail trade and wholesale trade have consistently grown at nearly the GSP growth rate. However, in 2008 both retail trade and wholesale trade are forecast to decline as a percent of GSP.
- Transportation, communications and utilities, manufacturing, and mining have historically grown more slowly than the economy as a whole. Together they accounted for 25% of output in 1992, but they are forecast to account for only 20% in 2008. Transportation, communications and utilities and mining are forecast to increase as a percent of GSP in 2008.
- The agriculture, forestry, and fishing sector and military sector declined as a percent of GSP from 1992 through 2000, but are forecast to increase in 2008.

Like the national economy, the Montana economy has increasingly become a service-producing economy rather than a goods-producing economy. Four sectors produce services almost exclusively: 1) finance, insurance, and real estate; 2) retail trade; 3) wholesale trade and 4) other services. Four sectors produce physical goods almost

exclusively: 1) manufacturing; 2) agriculture, forestry and fishing; 3) mining; and 4) construction. The other four sectors produce a mix of goods and services. Together, the service-producing sectors accounted for 49% of state income in 1992, and they are predicted to account for 53% of state income in 2008. The goods-producing sectors accounted for 20% of state income in 1992, and are forecast to make-up 20% of state income in 2008. The mixed sectors accounted for 31% of state income in 1992 and are predicted to account for 27% of state income in 2008.

Table 7 shows actual Montana wage and salaries, divided into fifteen sectors¹, for 1992, 1996, 2000, and 2004, and forecast amounts for 2008.

Table 7 Montana Wage and Salary Income										
Economic Sector	1992		1996		2000		2004		2008	
	\$ Million	% of Total	\$ Million	% of Total						
State & Local Govern't, Schools	1,167	17.9%	1,407	17.4%	1,652	16.6%	1,966	16.1%	2,324	14.7%
Educational & Health Svcs	731	11.2%	983	12.1%	1,265	12.7%	1,657	13.6%	2,141	13.5%
Retail Trade	650	10.0%	798	9.9%	971	9.7%	1,171	9.6%	1,416	9.0%
Construction and Mining	527	8.1%	685	8.5%	848	8.5%	1,166	9.6%	1,824	11.5%
Manufacturing	515	7.9%	590	7.3%	716	7.2%	685	5.6%	878	5.6%
Transportation, Warehousing, & Utilities	454	7.0%	524	6.5%	601	6.0%	639	5.2%	782	4.9%
Federal Government	417	6.4%	464	5.7%	566	5.7%	689	5.7%	787	5.0%
Wholesale Trade	355	5.5%	434	5.4%	507	5.1%	584	4.8%	752	4.8%
Professional & Business Svcs	403	6.2%	574	7.1%	802	8.1%	1,032	8.5%	1,553	9.8%
Leisure & Hospitality	348	5.3%	456	5.6%	544	5.5%	683	5.6%	888	5.6%
Financial Activities	327	5.0%	420	5.2%	559	5.6%	746	6.1%	1,061	6.7%
Other Services	199	3.1%	270	3.3%	325	3.3%	399	3.3%	463	2.9%
Military	154	2.4%	159	2.0%	168	1.7%	262	2.1%	293	1.9%
Information	143	2.2%	171	2.1%	234	2.3%	273	2.2%	338	2.1%
Agriculture, Forestry, & Fishing	120	1.8%	158	2.0%	206	2.1%	237	1.9%	317	2.0%

There are five sectors where total wage and salary incomes have consistently grown faster than in the economy as a whole: 1) educational and health services, 2) construction and mining, 3) professional and business services, 4) leisure and hospitality, and 5) financial activities. In three sectors, wage and salary incomes have grown almost as fast as in the economy as a whole: 1) information, 2) agriculture, fisheries and forestry, and 3) other services. In the other seven sectors total wage and salary incomes have grown, but not as fast as in the economy as a whole.

Economic Overview Summary

Wage and salary income in Montana is expected to grow by over 4.4% annually through 2009. Growth in non-farm employment is forecast to moderate in the next three years. Population is forecast to increase at approximately 0.5% annually. The Montana

¹ The growth in total wages and salaries for a sector is due to a combination of growth of employment in that sector and growth of average wages. These differ between sectors.

population is aging, as the 20-29 year age group is leaving the state and older people are moving into the state.

Oil prices have recently decreased, and are forecast to remain stable at the current, historically high price. Natural gas prices are forecast to increase and then level out at a historically high price level. High oil and natural gas prices will yield greater revenue for the state. Property taxes revenue is forecast to increase through 2009.

Generally, the economy has changed from a goods-based economy into a service economy. The impacts of the transition to a service-based economy coupled with an aging population should be monitored and considered in developing the future tax structure of the state.