Revenue and Transportation Interim Committee

PO BOX 201706
Helena, MT 59620-1706
(406) 444-3064
FAX (406) 444-3036

58th Montana Legislature

SENATE MEMBERS	HOUSE MEMBERS	COMMITTEE STAFF
ROBERT STORY--Chair	EILEEN CARNEY--Vice Chair	LEANNE KURTZ, Research Analyst
GREGORY BARKUS	JOE BALYEAT	JEFF MARTIN, Research Analyst
JERRY BLACK	RONALD DEVLIN	LEE HEIMAN, Staff Attorney
VICKI COCCHIARELLA	CHRISTINE KAUFMANN	
JON ELLINGSON	KARL WAITSCHIES	
KEN TOOLE	BILL WILSON	

MINUTES

November 16, 2004

Room 137, State Capitol
Helena, Montana

Please Note: These are summary minutes. Testimony and discussion are paraphrased and condensed. Committee tapes are on file in the offices of the Legislative Services Division. **Exhibits for this meeting are available upon request. Legislative Council policy requires a charge of 15 cents a page for copies of the document.**

COMMITTEE MEMBERS PRESENT

SEN. ROBERT STORY, Chair
REP. EILEEN CARNEY, Vice Chair

SEN. GREGORY BARKUS
SEN. JERRY BLACK
SEN. VICKI COCCHIARELLA
SEN. JON ELLINGSON
SEN. KEN TOOLE

REP. JOE BALYEAT
REP. RONALD DEVLIN
REP. CHRISTINE KAUFMANN
REP. KARL WAITSCHIES
REP. BILL WILSON

STAFF PRESENT

LEANNE KURTZ, Research Analyst
JEFF MARTIN, Research Analyst
LEE HEIMAN, Staff Attorney
FONG HOM, Committee Secretary

Visitors

Visitors' list, Attachment #1.

COMMITTEE ACTION
The September 9, 2004 minutes were approved as written on a unanimous voice vote.

CALL TO ORDER AND ROLL CALL
SEN. STORY called the meeting to order at 9:00 a.m. on Tuesday, November 16, 2004. Roll was noted by the secretary (see Attachment #2). Voting by proxy for the revenue estimate portion of the meeting will not be allowed.

JEFF MARTIN, Legislative Research Analyst, gave an agenda overview. SEN. STORY said that the Department of Justice will speak on the Tobacco Settlement, which will be discussed under revenue estimating.

MONTANA DEPARTMENT OF TRANSPORTATION LEGISLATION

Drew Livesay, **Administrator of the Motor Carrier Services Division,** discussed a bill that would add a new category to the annual overweight permit (61-10-125, MCA). Rep. Dan Fuchs carried legislation in the 2003 session that added two categories: a 30,000 lb and a 40,000 lb annual overweight permit. In that legislation, a 35,000 lb category was not included, which would have filled out all the incremental weight increases that the industry would like to see. This bill has the same requirements that are applied to the previous categories but with the 35,000 lb designation.

SEN. STORY asked if there was any fiscal impact. Mr. Livesay said that this particular permit category will generate about $15,000 more in annually permit revenue.

SEN. STORY asked if the Committee wanted to put this in as a committee bill. JEFF MARTIN said it would not be a committee bill, but would be by the request of the Department of Transportation. REP. WAITSCHIES moved that the proposal be included in the Department's package of preintroduced bills. The motion was approved unanimously.

Tim Reardon, Attorney with Department of Transportation, told the Committee that when they had presented their legislation in July, they had a bill draft request to eliminate the Department's obligation to establish a computer system to allow them to determine how much of a refund was due to off-road use for the 1 cent local option gas tax that might be raised in any community. No county has enacted that tax yet because of the cost; the first county that enacted the local option tax would have to pay the full amount. The Montana Association of Counties (MACo) was contacted and they have been working with the Department of

Transportation on this bill. MACo has agreed to carry this bill forward. The Department of Transportation agreed to the bill and supports it.

SEN. STORY asked if the Department has a percentage of the off-road refund that deals with gasoline. Mr. Reardon replied that he does not know the figures but it is not significant and the cost of setting up a system would be disproportionate to any collection. SEN. STORY asked if the collection of the local option tax, under the existing MACo plan, be done by the counties and not by the Department, and reimbursed to the counties. Mr. Reardon replied that it would. SEN. STORY asked if that is a current law or is that a change in the law. Mr. Reardon replied that the only change in the current law would be that the county will be responsible for establishing the refund process and how they are going to distribute that revenue. It has no fiscal impact on the Department other than it removes the potential costs that haven't been incurred yet.

ASSIGNMENT OF COMMITTEE SPONSORS FOR COMMITTEE BILLS

a. Eliminate the requirement that the Committee analyze the taxation of previously regulated natural gas suppliers (LC0163). SEN. STORY

b. Clarify fund transfers of certain vehicle taxes and fees (LC0164). REP. WILSON

c. Revise the notice requirements in an action to quiet title to tax deed (LC0166). SEN. COCCHIARELLA

d. Consider whether to cancel bill draft request for legislation regarding signs in highway right-of-way (LC0162).

The Department of Transportation had informed the Committee that they wanted to do an inventory of the signs and allow signs to stay on the right-of-way, but if the signs are in the clear zone, they will be removed. REP. WAITSCHIES asked if there was need for a motion. SEN. STORY said that the bill draft should be cancelled. The concern is that there are businesses and people in rural Montana who are worried about losing signage that informs the public of their location, etc. SEN. ELLINGSON said that if the bill draft request is pulled, it will put that request back into the hands of the Department to do what it thinks is appropriate, and if the Committee proceeds with the bill draft request, then the Committee would be putting into law what the Department may or may not do. SEN. BARKUS moved to cancel LC0162 and it was approved unanimously.

NATIONAL AND STATE ECONOMIC PERSPECTIVES

Dr. Paul Polzin discussed the national economic outlook (see Exhibit #1). He said that the national economy is expected to grow by 3% to 4% from 2005 through 2009. The positive factors affecting the US economy is new jobs, capital spending is on the rise, the federal deficit is leveling off, rising commodity prices, and economic growth in Asia. The negative side of the US economy is the rising and falling price of oil, consumers not spending as much, interest rates rising, the instability of the China's economy, housing market, the crash of the American dollar, and finally, terrorism.

Montana Forecast
According to Dr. Polzin, Montana's economy (see Exhibit #2) does not follow the national trend. Montana was not affected by the 2001 recession and the 9/11 aftermath to the same extent as the rest of the country. Montana slight decline in early 2001, was not due to the national recession. The national recession was concentrated in five industries: high tech manufacturing, dot.coms, communication, financial services, and airlines. The big five basic industries in Montana are: non-resident travel, wood products, agriculture, mining and the federal government. Montana's forecast shows that the state's economy will grow at historic rate.

REP. BALYEAT asked about the relative importance of economic sectors in Montana. DR. POLZIN said the figures using labor income as a measure are:

mining 8%
wood and paper products 10%
agriculture 11%
nonresident travel 12%
other manufacturing (manufacturing other than wood products) 13%
transportation (railroads and trucking) 16%
military 7%
federal civilian 23%

SEN. TOOLE asked if basic industries are what drives Montana's economy. DR. POLZIN replied that they drive and the causation goes from basic to the rest of the economy.

REP. WAITSCHIES said that Dr. Polzin talked about gross national product but not about state product but switched to income, could he explain that correlation? DR. POLZIN said that state income is closely related to gross state product. The problem is that gross state product numbers are not timely. He said that 2002 gross state product data has just been released.

Dr. Myles Watts, Department of Agricultural Economics and Economics, MSU, presented information on agricultural economics in Montana. Labor income in agriculture is very difficult to calculate. Dr. Watts believes that farm labor income is grossly understated. Agriculture is probably the most stable industry in Montana, generating about $2.2 billion of gross revenue. In recent years, about 1.1 billion of that has come from livestock, primarily cattle. The sheep and hog industry has declined. The state's major crop is wheat, which generates about 2/3 of the cash receipts. The next largest crop is barley, with hay being third.

Wheat outlook. It is expected that next year will be a typical year in terms of yields of production. However, some things that we should be concerned about are: Yields were off nationwide, acreage was down, but worldwide production is up 12%. Montana produces a lot of high protein wheat.

Cattle outlook. We continue to have lower US cattle numbers, particularly beef cows and heifers. If we open the Canadian market, we're going to end up down a little bit less than $4.00 on hundred weight on our prices. If we open the international markets with Japan and the other countries around the world, we're going to be up about $4.00 a hundred. We have maintained our non-edible byproducts market, primarily hides. The hide market is worth about $4.00 a hundred weight as well. Last category is edible byproducts, and if we can open those markets, that's worth almost another $4.00.

Opening trade with Canada would link Montana to Japan. He thinks that Montana will end up with cash revenues somewhere between $150 million to $200 million above the 2003 revenues. There will continue to be some growth in the next year, because protein premiums on wheat will go higher.

SEN. ELLINGSON recalled that most of government payments are for crops as opposed to livestock. DR. WATTS said it is dominated by crops but there are some water development projects attributable to livestock. For all practical purposes, 95% of federal payments are crop related including traditional government payments, crop insurance subsidies, and development programs, such as water development.

SEN. BLACK asked if we allow the Canadian beef to come down, is Canada giving us any concessions about allowing beef back into Canada? DR. WATTS said that it will flow both ways.

TOBACCO SETTLEMENT FUND

Kelly O'Sullivan, Assistant Attorney General, Department of Justice, talked about the Master Settlement Agreement, an agreement that was reached between four manufacturers and the various states. Since that time a number of other manufacturers have joined, as have other jurisdictions. At this point, there are about 50 tobacco manufacturers and 47 states and jurisdictions that are involved in the settlement.

Roger Lloyd, Legislative Fiscal Division (LFD), said that there is basically two issues in trying to estimate this revenue source (Exhibit #3).

1. The first issue is the adjustment for non-participating manufacturers.

The Budget Office's estimate is less than the LFD's because the Budget Office concluded that the non-participating manufacturers adjustment will be taken and the states will not receive their money. LFD assumed that the adjustment would not take place because of the uncertainties in the adjustment being applied. The question for the Committee is, whether to apply this adjustment. The Attorney General's Office informed the LFD that the Settlement Agreement really doesn't provide for withholding money from this adjustment because it is not a disputed amount. If an amount is disputed according to the agreement, then the company is going to withhold the money. However, LFD was further told that because these companies think that it's a disputed amount, that they could very well withhold the money anyway.

2. The other issue is that there are a number of other adjustments that happen to the payments that the companies pay to the settling parties.

Two of the most common are an adjustment for inflation and an adjustment for volume. The inflation adjustment increases payments to the states either at minimum rate of 3% or the actual rate of inflation, whichever is greater. If the number of cigarettes shipped nationally declines, then payment to states declines as well. This adjustment has always decreased the amount of payment that states receive. The question on this is what rate do we assume that these cigarette shipments will decline. The decline rate on the table is constant. The Budget Office also estimated its own decline rate at a little less than the LFD by applying a historical average of previous years. The other question, what decline rate do you want to use in estimating this revenue source?

Judy Paynter, Office of Budget and Program Planning, said that when OBPP was preparing a non-participating manufacturers adjustment, the Attorney General's Office told them that they expect the non-participating manufacturer adjustment amounts into disputed accounts. It could involve a very large amount of money, about $5 million a year in 2006 and 2007. OBPP believes it is prudent to assume that the dispute over the non-participating manufacturer adjustment will not be resolved prior to the FY07 payment and that the participating manufacturers will withhold the maximum adjustments in fiscal years 06 and 07.

Cigarette shipments and volume reductions. The difference between the LFD and the Budget Office numbers is that the Budget Office used a fiscal 2000 to fiscal 2005 annual average change, which was a decrease of 4.19%. The LFD used the 2004 change of 5.64. If the higher rate is used, means less money in the revenue estimate.

SEN. STORY asked about Table 7 on page 179 (executive revenue estimate).

Ryan Jose, Tax Policy and Revenue Analyst, Budget Office, said that Table 3 on page 174 breaks down all the components of the Master Settlement Agreement payments. The very bottom line, assuming that the MPN adjustment would be made, total revenue would be $26.4 million in 2005; $21.5 in 2006; and $21.3 million in 2007.

SEN. STORY asked what the revenue would be if they weren't made? MR. JOSE said the non-participating manufacturer adjustment would be approximately $5 million a year.

REP. DEVLIN said that if there's a disputed amount that goes into escrow or we don't get the payments, once that's resolved, then each state will get what's coming to them, then what happens if it's more than the disputed amount that they withhold and they find there was even more market share lost, do the states then have to refund that money? MS. O'SULLIVAN said the state has not faced that situation yet. What they have done is offset future payments by the amount that was overpaid in past years.

REP. BALYEAT asked LFD about the differences in the adjustments and whether they balance out. MR. LLOYD said that they do not come close to balancing each other out. The non-participating manufacturer adjustment is a large proportion of the total differences. The small difference in the decline rate adds very little to the difference. Over the three year period, we are off $8.5 million in total revenue and general fund portion of that is 11%.

REP. BALYEAT said that he's not sure he fully understood the volume decline component. He wanted to the know that, in calculating this volume decline component, if any attention was paid to the fact that various states, including Montana, passed substantial tobacco tax increases. How has that affected demand and is that reflected in our estimates? MR. LLOYD answered that one of the reasons LFD kept it the highest rate of the 5% figure is because in the past, the rates that were chosen were always exceeded by what actually occurred, and that's the reason it is kept at last year's rate rather than saying that the rate of decline is going to slow down.

SEN. STORY asked when the settlement was first made and the State's share was set, would consumption drop faster than the national average and does the State's percentage of that revenue drop, or are we locked into the original share? MR. LLOYD said that we are locked in but the Master Settlement Agreement has the percentages listed in statute what each state gets.

SEN. ELLINGSON wanted to know if one could identify the companies that are claiming to be losing market share and who they are losing market share to? MR. LLOYD said there are approximately 43+ subsequent participating manufacturers, plus the big four that originally signed the Master Settlement Agreement. If they prove that they have suffered a market loss due to the disadvantage caused by the Master Settlement Agreement, then they're entitled, if other conditions are met, to adjustments or a decrease in the payments they owe the states.

SEN. STORY asked KELLY O'SULLIVAN that if a participant filed suit, how long will that proceeding take and will the filing suspend payment, or would they have to have some action before they could do that? MS. O'SULLIVAN said that the MPM adjustment will be decided either state by state in state court, or it'll be decided altogether in front of some panel of arbitrators. That decision is separate from the tobacco company's decision to withhold money.

SEN. ELLINGSON asked if every state has to be diligently enforcing, and MS. O'SULLIVAN said yes. SEN. STORY asked she was aware of some states that are not making some type of effort. MS. O'SULLIVAN said that there are some states that view this differently than Montana does. There are states that have not taken the same tack in terms of suing tobacco companies that don't put money into escrow. There are also states that took money in 1999, straight off the top of the MSA funds, and established a tobacco enforcement unit and they have attorneys and investigators and auditors and all they do is enforce the tobacco legislation. SEN. STORY asked what percentage of money is at play here, is it $5 million off of $25 million per year or what? MS. O'SULLIVAN said the withholding would be, at least when the OPM start to withhold, about 20% of the tobacco money each year.

STATE AND NATIONAL ECONOMIC OUTLOOK FOR REVENUE ESTIMATE

Terry Johnson, Principal Fiscal Analyst, Legislative Fiscal Division presented key economic assumptions that were used in deriving the revenue estimate for the general fund and certain other nongeneral fund accounts. Individual income tax is by far the largest source of revenue in the general fund. The second largest source is property tax. There are smaller components, such as corporation income tax, investment earnings, and natural resources. When you add up all of those sources of general fund revenue, they produce about 70% of the total revenue collections in the general fund for any given year.

SEN. BLACK passed out a handout (see Exhibit #4) and said that this was a critique of the Rail Freight Competition Study at the request of the Montana Grain Growers and The Montana Barley Association. There are some important things that contained in the critique that would be useful in evaluating the railroad competition within the state of Montana. SEN. BLACK said that this will be an issue coming up during the next session.

Dan Dodds, Office of Budget Program Planning passed out The Montana Economy, Trends and Implications (Exhibit #5), and commented that his numbers will be different from the ones seen this morning.

Terry Johnson, Principal Fiscal Analyst, Legislative Fiscal Division, gave the Committee two handouts that showed (see Exhibit 6 and Exhibit 7) LFD's joint effort with the Executive Budget Office in comparing the revenue estimate recommendations. The key thing is a three-year difference between the revenue estimates as recommended by the respective offices. And for approximately 4.3 billion dollars worth of revenue over that 3-year period, there's a difference of about $34 million.

However, both offices believe that there are three specific sources of revenue that should be discussed: individual income taxes, oil and gas production taxes, and common school interest and income. In addition to those three specific sources, there are three issues: the tobacco settlement funds, Initiative 149, and interest income from long-term type investments, primarily capital gains on state bonds. Those are the six areas that we would recommend the Committee spend its time on.

SEN. ELLINGSON asked where the decline rates for cigarette consumption came from. MS. PAYNTER said that there are two decline rates. The Budget Office used the average decline rate from 2000 through 2004 of 4.19%, while the LFD used the actual 2004 decline rate of

5.64%.

SEN. TOOLE asked when does the tax from the initiative start. SEN. STORY said January 1.

REP. BALYEAT made a motion to adopt the LFD decline rate. He pointed out that the decline rates that had been used in the past were always exceeded by the actual decline rate. It is more reasonable to use last year's decline rate for future projections.

SEN. ELLINGSON wanted to discuss this in more detail and get more information. He said that the LFD picked 5.64% and the Budget Office picked 4.19%. Is there some national organization that estimates decline rates, have we taken into consideration anybody else's numbers on this, or are we just flying by the seat of our pants and picking numbers based on our hunches? MR. LLOYD said that it might be a hunch going off last year's. But when you get into a discussion about the cigarette tax, you will be hearing decrease rates of between 7% and possibly 9% or 10%, rather than the 5% that is being reported now.

SEN. BARKUS wanted to know that if the LFD is showing a larger decline in volume, why the tax revenue on line 20 of the spreadsheet is significantly lower than the Executive's? MR. LLOYD said that is the first issue that was discussed earlier this morning, the non-participating manufacturers adjustment, which the Budget Office included and LFD did not. If you include that adjustment, that decreases the payments by about 18%.

REP. BALYEAT asked for clarification of line 20. He said the actual fiscal year 2004 cigarette tax collected was $36 million, then it was estimated that for 2005, it will go up to $40 million. But from then on, the LFD's projection each year after that dropped, showing a decline. It drops to $38 million in 2006; $36 million in 2007, roughly a 5% decrease each year. He would like confirmation of that. TERRY JOHNSON said that they did make an initial calculation on the effects of Initiative 149, and that is reflective in the numbers that are shown on line 20 for cigarette tax. That was our initial attempt to factor in the additional tax increase due to Initiative 149.

REP. WAITSCHIES asked why the full impact is not shown on the table. TERRY JOHNSON said that is the general fund impact, but the larger impact is that some of this tobacco settlement money goes into a state special revenue account that funds public health and service programs and that total number is probably in the range of about $8.5 million. MS. PAYNTER said that the effect of that motion is about $400,000 in 2005; $640,000 in 2006; and $950,000 in 2007.

REP. DEVLIN said that a conservative view should be taken on those numbers. The Committee should take the LFD decline rate.

SEN. STORY **the vote is on a motion to adopt for the decline in national volume, the LFD number of 5.6362% for all three years of the revenue estimate.** Motion passed unanimously.

PROTEST FUND

REP. DEVLIN said that he thought it was in the tobacco settlement. The Executive assumes that the money would be put into escrow and LFD does not. MS PAYNTER said when you're talking about this money going into escrow, it makes about $5 million a year difference for fiscal year 06 and fiscal year 07.

SEN. STORY wanted to know if that was LFD's number also, and MR. JOHNSON said yes.

REP. DEVLIN said that in light of what came up and both sides are in agreement on that figure, he would like to make a motion that the tobacco settlement funds reflect that number, assuming that this money will be held in escrow, rather than disburse it to the state.

SEN. COCCHIARELLA asked what is the effect of both motions. JUDY PAYNTER thought that the first motion was worth, over the three years, about $2 million. The other motion is going to be worth about $10 million less.

SEN. TOOLE wanted to make sure he understood the escrow issue. He commented that if one state is not enforcing the settlement appropriately, then will they put their money in escrow for all states? Have they already been putting money in escrow? Has there been any refusal to pay yet? SEN. STORY answered no, that the settlement was signed years ago and payments have been made up to this point. They will be made this year and maybe in 2005. Then in 2006 and 2007, they are at risk because of changing circumstances when the original settlement was only four companies and as more companies joined, things start shifting around and you start wondering about whether they're overpaying.

SEN. TOOLE asked if the money that would come to state government in Montana has been put into escrow in past years? MR. LLOYD said they put part of the total payment in escrow. SEN. TOOLE asked how is that calculated in the numbers that we're looking at and how is that assumption treated? MR. LLOYD said Price Waterhouse, the independent auditor, identified market share loss and not the amount of money to be withheld from the states because that has to be determined that loss of market share was substantially due to them signing the Master Settlement.

REP. DEVLIN said the Justice Department indicated that in April of 2004, Price Waterhouse had identified that there had been a loss of market share, that they were going to determine whether that was caused by non-participating manufacturers, and if there's a loss of market share, there will be arbitration to prove that this is going to come up. My motion was that we're going to receive the full amount in 2005, but to subtract 20% or $5 million each year for the 2006, 2007, because of the potential of litigation.

SEN. STORY said seeing no other discussion, **a motion was made by Rep. Devlin that the tobacco settlement funds reflect that we take the number, assuming that this money will be held in escrow, rather than disburse it to the state.** This motion was passed.

<u>INITIATIVE 149</u>

TERRY JOHNSON explained that the issue here is dealing with the Initiative 149. Kathy Duncan passed out information (Exhibit #8) providing a framework for the Committee to deal with Initiative 149 which will increase the cigarette tax by a $1.00/pack, and also increase the tax on moist snuff and other tobacco products. Legislation is effective on January 1, 2005. The Governor's Budget Office has formulated a revenue estimate to take into account the fiscal impact of the initiative. That is shown on line 20 and also on line 31 of the comparison sheet.

Kathy Duncan, Legislative Fiscal Division, said that what the Committee is looking at is the change in demand for cigarettes because of a tax increase. This particular issue was addressed in SB 407 when there was a cigarette tax increase. At that time the fiscal note used an elasticity value of -.44% for a 1% change in price, which amounted to a 7.3% decrease in consumption. In 2004, the actual revenues came in just about $1 million higher than the estimate. On January 1, Montana's taxes on cigarettes are going to be two and a half times higher than any of the surrounding states. People may go to other states or purchase them on the Internet. LFD used an actual short and long-term elasticity factor, an elasticity of a -0.4% for a 1% increase in price, and then a secondary factor of a -0.2% in the second year for a 1% increase in price. That amounted to a decline of 15.5% in consumption over what it would have been without the price increase. That is reflected in the numbers we have right now. After some research and a chance to talk to a national expert in this field, Bill Orzechowski, it was recommended that Montana consider elasticity of -0.8 for a 1% increase in price, which would amount to approximately 21% decrease in consumption. In the fiscal note for SB 407, the same rate was used as was used for tobacco products. When we derived our estimates, as shown on page 200, that LFD instead of using a 0.4% decrease for first year elasticity, -0.35% for a 1% increase was used.

Judy Paynter, Budget Office, passed out their report on Initiative 149, (Exhibit #9). Increases of taxes on cigarette packs to $1.70 per pack; $.85 per ounce of moist snuff; and 50% on all other tobacco products. The magnitude of increase is an increase of a dollar for cigarettes, $.50 per ounce for moist snuff, and 25% on all other tobacco products. It is anticipated that taxable consumption will be appreciably affected. Montana is now one of the highest four for rates on cigarette taxes. A change in consumption is measured and anticipated with the use of price elasticity of demand.

REP. BALYEAT made **a motion to accept the LFD number of -0.8% elasticity**. He believes that there will be a substantial amount of cigarette purchases, not just from surrounding states, but also through Internet purchases and because the tax rate in Montana is so high relative to the rest of the United States, that will make the Internet component even higher.

SEN. STORY asked for further discussion and hearing none, said Rep. Balyeat's **motion to accept the elasticity numbers of the LFD, a -0.8%,** passed unanimously.

INCOME TAX

SEN. STORY said that he would accept a motion to adopt the LFD revenue estimates, then make amendments to those numbers with the exception to those amendments already adopted. **SEN. ELLINGSON moved to adopt LFD estimates for the remaining revenue items.**

COMPARISON OF FISCAL DIVISION AND EXECUTIVE BRANCH REVENUE ESTIMATES

Jim Standaert, Legislative Fiscal Division, gave LFD's comparison of estimates of income tax (Exhibit #10). These estimates include SB 407, which was passed during the 2003 session. SB 407 lowered the tax rates on each bracket of income and instituted a capital gains credit of 1%, starting January 1, 2005. That capital gains tax credit will increase on January 1, 2007, to 2%. The third thing SB 407 did was cap deductibility of taxes paid to the federal government at $5,000 for a single taxpayer and $10,000 for married taxpayers.

The differences between the Legislative and the Executive estimates for income taxes for three years is $4 million. The Budget Office has $25 million more revenue in 2005; they have $20 million less revenue in fiscal 2007. The main reason for this change is major assumption differences is listed in the handout. Mr. Standaert said that LFD used a 0% growth rate for capital gains.

REP. BALYEAT asked why 0% growth rate? MR. STANDAERT said there was tremendous growth in the 2003 capital gains realizations that were reported on the Montana returns. There was a 24% increase in 2003 over 2002. There was a large increase in the stock market in 2003. REP. BALYEAT said that even if the stock market is at the same level now as it was in the beginning of 2004, wouldn't you say that there should be no capital gains component at all? MR. STANDAERT said capital gains are made up of both stock market gains and other gains from other types of sales.

SEN. TOOLE asked if there was a way to separate the area on wages and salaries growth into how much comes from energy related, oil, gas, coal? MR. STANDAERT said that could be done. He did look at what was happening to mining and employment last year in all those industries and it was up substantially in 2004.

SEN. BARKUS asked Mr. Standaert if he could defend his zero capital gain projection versus the Executive's 17.2%? MR. STANDAERT replied that capital gains were taken from S&P 500's forecasts. We have a tax benefit rule. When SB 407 kicks in, there's going to be a cap on the federal deductibility for all those people who pay enough federal taxes to hit that cap. But once an individual hits that cap, should he be forced to report as income his federal refund from the prior year when he didn't get the benefit of deducting all his federal taxes. The tax benefit rule is a well-established rule around the country, it says that a person should not have to report his income, his federal refund when he was capped in the prior year. So we have about $275 million with the federal refunds every year that we tax, now we're going to cut out a big chunk of that federal refund income as reported income for those people that hit the cap on the federal deductibility. We figure that it's going to happen in fiscal 2007. In summary, 2005 will be the first year that SB 407 will go into effect. People will pay their federal taxes; They will get a refund in calendar 06. The State is going to lose about $6.6 million because of that. The Executive makes a couple of adjustments related to withholding. A portion of income taxes is used to pay for DOR's computer system rather than going into the general fund.

Dan Dodds, Office of Budget and Program Planning, passed out a couple of handouts (Exhibit #11). This is a comparison of the calculation of our results using exactly the same model that the LFD used plus there is an additional change in there that is not in the original revenue estimates. This is the tax benefit rule. Our estimate for fiscal year 2005 is about $25.1 million over the LFD estimate; in fiscal year 2006, we are about $8 million under; and about $20.7 million under in fiscal year 2007. The total comes out to a little less than $4 million. Both LFD and the Executive are saying that growth in 2004 is going to be higher than 2003 although the LFD's projection is not as high.

SEN. COCCHIARELLA said that she is concerned about both numbers, especially the Budget Office number because its individual income tax estimates $20 million lower in FY07. She asked Mr. Standaert to respond. MR. STANDAERT said that if she is talking about total revenue, SB 407 will be coming in which lowers the rate. If you're talking about the wage growth that the Budget Office has, they've got 3.3%, 3.4% in 06 and 07. I don't believe we've had wage growth that low since the middle 80s.

SEN. COCCIARELLA said that she is very concerned that the emphasis has been on our economy, growing jobs, economy development for at least the last five to seven years, and she did not believe that things have gone so poorly and we've been sheltered from all the negative impacts, that we're going back to 1985 in the area of growth. She did not agree with the LFD's number for 2005. Those numbers are very conservative and she did not agree in the individual income tax assumption from the Budget Office, especially in wages and salaries.

SEN. STORY said that there are several things we need to work out here because the motion is to accept the LFD's growth rates. If someone wants to go with the Executive's then they will have to discuss that issue.

REP. DEVLIN, referring to Mr. Dodds' handouts, said that these are numbers that have come in and will affect the tax collections based on calendar year 2004. Fiscal year 2005 will be the bulk of it. There is no tax law changes that goes on during that period of time. SB 407 doesn't kick in, we have had federal changes already in place for all of this. What degree of accuracy can we put on this as far as our calendar year 2004 collections will be? Are we going to see a growth rate of over 6%? MR. DODDS said that these are all actual numbers, both this fiscal year and last year. This is what withholding has grown from last year. If you look at all of fiscal year 2004, you see about the same growth in withholding.

REP. DEVLIN said in regard to collections so far, the tax changes don't kick in until after tax year 2004, showing a better than 6% increase in individual income tax, and your projections from them are because of changes in tax law and a few other things, then you're going to drop down, your growth rate from 6.5% down to under 5%, that's primarily due to changes in tax law that take effect in January? MR. DODDS said that two things are happening. There is going to be a reduction in tax liability, whatever happens to growth in wages and salaries. The other thing that is happening is that we're not going to see this rapid growth in wages and salaries continuing. One reason for the rapid growth for the last year, year and a half, is that we're coming out of a recession, and coming out of a recession you have people going back to work, you have people finding better jobs who had to temporarily take a job that wasn't so high paying. So during a recovery, you typically see faster than normal growth in wages and salaries, then as we get closer to full employment, that growth slows down to more like the long-term trend.

SEN. STORY asked Mr. Dodds about $1.7 million and $2.7 million in audit collections. How does that relate to the $25 million that we're talking about later in the process? MR. DODDS said that audit collections aren't steady from month to month, so it is hard to say whether they are going to be up over the year.

TERRY JOHNSON commented on audit collections. There are three categories of audit collections: prior year amended income, true audit collections, and penalties and interest. Based on data through October 2005, and adding those three categories together, you have $8.5 million that has been collected. The comparable period in 2004 is $2.8 million.

REP. BALYEAT thinks that the Budget Office is a closer estimate of how capital gains are going to track. Because of that one factor, he would accept the Budget Office numbers. He also thought that the Budget Office's adjustment made for tax benefit is correct. He did not know if the Committee was going to go through each individually or if the Committee will accept one or the other, but if the Committee is going to accept one or the other, he thinks that the Executive Branch number with respect to capital gains should be used.

SEN. STORY wanted to understand how the tax benefit number of $8 million moving from 2006 to 2005 worked. Are people going to overpay in 2005 and we'll end up refunding that money in 2006. JIM STANDAERT said that this is not the tax benefit rule. The withholding transition into SB 407 is different than the tax benefit rule. Accountants are going to tell taxpayers that they need to change their withholding on January 1 of 2005.

SEN. STORY said that if they do that, then people will not pay that money in 2005, and Jim Standaert agreed. SEN. STORY said we won't have to refund it in 2006. In the end it's money out of the total biennium, and both projections is just that one leaves the system. You're expecting it's going to leave the system in this biennium? JIM STANDAERT said that was correct.

REP. BALYEAT made **a motion to accept the Budget Office numbers on the income tax in total.**

SEN. DEVLIN wanted to know if this motion was an amendment to the original motion, so the motion still is to adopt the Fiscal Division's numbers, except that we adopt the Budget Office's numbers in income tax.

SEN. ELLINGSON said there is a question on procedure. The motion now is to accept simply the Executive's, but there are a lot of questions in a lot of these different subcategories.

SEN. ELLINGSON said he would vote against the motion as it is presented for a number of reasons. First, wage and salaries is the biggest component of our income tax. While I might be willing to support Rep. Balyeat's critique to a certain extent of capital gains growth, I don't think that makes so much difference and I do think that the Executive has overestimated growth in calendar 04 and underestimated it in the outlying years. I think the LFD's evaluation of that growth component is better. In terms of capital gains growth, I don't know that the evidence substantiates that we're going to have a 17.2% increase in capital gains growth in calendar 2004. I'm not comfortable with a 10% decrease. I don't see the evidence of that. This process is seeming to be quite a bit more complex than some of the issues that we've dealt with in the past, as we have estimated revenue.

REP. BALYEAT withdrew his motion to accept Budget Office's number in total and instead made a motion to accept the Executive figures with respect to the capital gains growth and with respect to the SB 407 adjustment, the $8 million, just those two items.

SEN. STORY said that if you believe that that's where capital gains are going, the numbers will come out the other end of the formula. If you don't believe that's where they're going, we're going to sit here and move numbers until we get $5 million out of this and that's not what we really want to do. If you think one or the other is in the right place, this will get to them again in House Taxation Committee, but we need a place to start so they can start doing fiscal notes when the session starts.

SEN. TOOLE said that's exactly my question. So if you vote for this motion, you basically think that capital gains are going to drop 10% in calendar year 2005, and that's all set aside for

SB407? So, in essence, you think something is going on out there in the values of either stocks or investments that's dropping in 10% in a year, or both.

SEN. STORY asked Dan Dodds if that was his assessment that something's going to take a big bite out of the capital gains. MR. DODDS said the way he would characterize it is that we're going to have another one year bump up in 2005, and then we're going to drop back down, so we're going to see some extra gains in 2005 from people selling assets they bought at the bottom of the market.

SEN. TOOLE said that if you vote for this, you're saying that something is driving capital gains income down 10%. No growth, it's going down 10%.

REP. BALYEAT gave his interpretation of the Budget Office's rationale for their predictions on capital gains. He said that if you look at the chart that was provided by the Budget Office, you will note that back in the years 1998, 1999 and up to 2000, the capital gains did not exactly track with the S&P 500 reported capital gains. It took a dip. Dan tried to explain that people were selling off investments, which they bought on the way up, and they did not have as big a gain as they did in the previous year. Dan thinks that there is going to be a similar thing happening where if the stock market continues to rise because they're selling off investments that they made later, they're not going to have as big a gain on those investments as the ones that were sold in 2004. I agree with Dan in that what I see happening with individual taxpayers, you're going to see the same thing happen in 2004 and 2005 that you saw in 1999 and 2000. And offsetting their carryover losses that they could only take up to $3,000 per year. They can take losses to offset all their gains for that year, plus an extra $3,000. That is why I think that the Budget Office's numbers with respect to these capital gains are probably more accurate.

SEN. ELLINGSON said, for discussion purposes, that if you go back and look at the trends, there is a general relationship with the S&P going up. There are a couple of situations that I can point to where the S&P has gone up and capital gains have gone down, but the prediction is that the S&P is going to go up. SEN. BARKUS said that he agreed with Sen. Ellingson that it is a guess, but the one thing we do know is that there is going to be tax relief for capital gains in 2005 and 2006, that is factored into SB 407. The tax benefits for capital gains will stimulate sales to create capital gains.

SEN. STORY said there was a **motion to accept the Budget Office's numbers for capital gains and for that $8 million shift.** Roll Call Vote (see Attachment #3) Motion fails on a tie vote.

REP. BALYEAT asked if it was back to the original motion? SEN. STORY replied that it was original motion.

OIL AND GAS

JIM STANDAERT compared the oil prices and oil production between the two offices. The LFD estimate is above the Executive by a little over $600,000 to $700,000 in each year. In the third year the LFD drops below the Executive in terms of revenue estimate. Oil production is going up. The last year was about 19 million barrels. The oil price is below the Executive in two of the years. In the middle year, LFD is above by a little over $1.00. Gas production is going up. The gas price is slightly higher. We use a calendar year method and the Executive uses a fiscal year method in deriving the estimate.

DAN DODDS gave the Executive's outlook for oil and gas. His handout showed similar information as the LFD's but he doesn't think there's the same kind of risk as Jim was saying. When we did our estimates earlier in the fall, as prices kept going up over $50, we did not raise our estimates in response to that. There are significant forces out there that are going to keep oil prices higher than they have been for the next five years. We have rapid growth and world demand, which has outstripped growth and production capacity. That's going to keep prices up. Our weak dollar is projected to continue to fall relative to other currencies. That's going to continue to make all of our imports, including oil, which we import more than half of, more expensive. And it's going to take time for supply to expand to meet the demand. Prices are going to come down, but they're not going to come down rapidly.   In terms of output, we have had decades of falling oil production in Montana, and suddenly it's going back up. I think we're going to continue to see that for the next couple of years, and that's what driving the executive's higher production assumptions. We have more than twice as many drilling rigs operating in the state now as we did three or four years ago. Those rigs are going to keep operating as long as the price doesn't go back down in the $20s. We are going to continue to see growth in oil production, which we haven't seen for decades.

Natural gas. For a long time we had flat natural gas production. The last five years or so, natural gas production has grown by leaps and bounds. We've set new records almost every year. With prices up, I don't see how that trend can slow down.

SEN. TOOLE made **a motion to accept the Executive numbers for oil and gas production taxes.**

SEN. STORY had a question for Jim Standaert. When you're talking production here, is this total production, or is this taxed production, or is there a difference anymore? MR. STANDAERT replied that this is total production. Some production occurs on Indian lands or government lands that is not taxed. SEN. STORY asked about the horizontal drilling incentive. MR. STANDAERT said that there is the 18-month holiday on oil and gas and 12-month holiday on new oil and gas production.

SEN. STORY asked when you calculated the oil production, how much of that new production is actually taxed? MR. STANDAERT said the LFD calculates it on a prorata share. We don't know where that production is taking place and there's a certain percentage of production that takes place on government lands. We apply that same percentage to old production and new production.

DAN DODDS said estimates are done for each production category, which is subject to a different tax rate. We do an estimate for new production which is subject to a tax rate, then we do an estimate for production from wells that are a year or more old, which is subject to the higher tax rate.

SEN. BARKUS does not believe that oil prices are sustainable, and when the prices get back down in the mid-30s, a lot of stripper wells will shut down in Montana because it's not economically feasible. He shares Jim Standaert's concern that these numbers are too high across the board.

SEN. COCCHIARELLA supports this motion.

SEN. BLACK could not support the motion because he doesn't think that the demand for oil will decrease, but we should be more conservative in the estimate. As we settle the situation in Iraq, and as oil companies increase drilling there will be a large supply of oil to meet the demand. There will also be alternative energy meeting that demand. He would rather err on the side of caution.

SEN. STORY asked for other discussion and seeing none said the question has been called. **The motion is to take the Executive's oil and gas estimates**. Motion passed.

INTEREST, LONG-TERM INTERESTS, COMMON SCHOOL'S INTEREST IN INCOME

ROGER LLOYD compared interest and income for the common school trust fund (Exhibit #12).

He listed the differences based on the four major interest and income components of the trust: royalties, timber, interest from the balance of the trust, and the income components. The Executive has a considerably lower rate than the LFD. Since the Committee has taken the Executive's oil and gas recommendations, that will change the number but he did not know by how much. The $2 million figure difference in the royalties has been changed by the Committee's previous motion.

DAN DODDS also compared the differences. There are two individual items where the Executive and LFD differed: rent to state lands for agriculture and state grazing fees. The forecasts for wheat prices from the US Department of Agriculture and the Future's Market showed reductions over the next few years with the Executive's estimate about $1.2 million above the LFD's estimate.

The Board of Investments earns net capital gains when it sells bonds that are held by the Board. In 2004 we had $12.3 million in capital gains in the sale of bonds. That increases the overall return on the trust fund bond pool by about a percentage point. We predict significantly lower capital gains in fiscal 2006 and fiscal 2007. The result of that is a big drop in the overall rate of return that the trust fund bond pool is going to be paying to the various trust funds in fiscal 2006 and fiscal 2007.

SEN. STORY called for discussion and seeing none, said that the LFD numbers are the numbers.

TERRY JOHNSON wanted the Chairman to know that based on the Committee's action in the case of the interest and income category, the Committee had implicitly taken the action to make no change, and that would apply to the trust fund bond pool. It affects not only the interest and income account, but it also the permanent trust account. That was the last issue that was going to be addressed and the fact that the Committee addressed it here, there will not be a need to address it again. SEN. STORY said that when we addressed it here dealing with specifically interest and income accounts, that dealt with a certain pool of money, $40 million, $45 million and if we dealt with it in the global picture, how much money are we talking about? TERRY said it affects the Permanent Trust Account, Tobacco Trust earnings, a number of other coal tax trust terms. He did not have the exact amount.

SEN. STORY said that if we took the Budget Office's numbers and applied them to all this as it compared to your numbers, does the money available go up or down? TERRY said the money available would go down by roughly $5 - $6 million per year.

SEN. BARKUS asked about discrepancy between sub(d) in the Executive's report regarding the corporate income tax. KATHY DUNCAN, LFD, said that over the past couple of years an adjustment on corporate income tax for bonus depreciation was made. The federal bonus depreciation gave corporation an advanced writeoff on their taxes and cut into our corporate taxes as well since we are tied to federal law. Bonus depreciation gave corporations more money immediately but costing them later in tax terms. We are expecting corporations to make a recovery and expect them to start paying more taxes, with fewer refunds upcoming in the next two to three years.

REP. DEVLIN moved that the Committee accept the Executive number on the corporate tax.

SEN. TOOLE thought that the Committee should stick with the LFD estimate.

SEN. STORY asked for a discussion.

SEN. ELLINGSON wanted to hear what the LFD had to say about their numbers again.

KATHY DUNCAN said there is a return to almost a base value in the corporation tax. We have had a relatively constant tax base or tax liability right around $70 - $80 million. In 2005, it will be a little lower. In 2006, it will go up because of bonus depreciation. In 2007, it will go back down to a more normal range.

REP. WAITSCHIES asked about loss carryover to future years, including what it has been in past years and right now. KATHY DUNCAN did not have the exact figures but said that the way our taxes work with refunds in carrybacks and carryovers, you carry back first and then you carry forward. Much of corporate loss that was experienced in 2001 and 2002 was used as carrybacks. However, the refund activity has changed this year. You have a carryback and you get the refund. The refunds are tracked but remaining carryforwards after the three-year carryback are not tracked.

SEN. STORY asked for a vote on **the motion to accept the Executive numbers**. The motion failed on a roll call vote (see attachment #4). **The motion to adopt the revenue estimates as presented passed unanimously.**

SEN. STORY wanted to thank the staff of both agencies for the work they did. The Committee appreciates the work that was put into developing the revenue estimates.

NONGENERAL FUND REVENUE ESTIMATES

TERRY JOHNSON did not prepare a sheet on all of the nongeneral fund sources. When you adopted some of the various general fund sources, you implicitly adopted some of the nongeneral fund. For example, when the Committee adopted a general fund estimate for the tobacco settlement it implicitly adopted the state's special revenue portion. There are other sources of revenue, in particular, that do not have that link. Two good examples of that is the gasoline tax revenue and the diesel tax revenue. Those are two very large sources of revenue. The reason that we'd like to have action on those is because those are used in the budget process for determining the Department of Transportation budget.

SEN. ELLINGSON moved **to adopt the LFD estimates for the gas tax and diesel fuel tax. The motion was approved unanimously.**

JEFF MARTIN said that Roger Lloyd brought up the point regarding the ending general fund balance in the joint resolution. JEFF MARTIN didn't recall whether that number has always been the audited amount or whether it was the unaudited amount and then changes made in the tax committee. TERRY JOHNSON thought that two years ago that was exactly the situation where they had a preliminary number that had not been audited yet by the Legislative Auditor and the Committee adopted the preliminary number with the full expectation that that number could be adjusted once the audit was issued by the Legislative Auditor.

SEN. STORY wanted to know if the Committee wanted to have the unofficial number put in or to have the audited number used in the original printing of the resolution?

JEFF MARTIN reminded the Committee that the resolution needed to be preintroduced in the time the audited general fund balance is determined. TERRY JOHNSON thought that the Committee would be in some what of a quandary because there would not be a balance to start from, and so he recommended that the Committee adopt a preliminary number with the option of amending it.

REP. DEVLIN moved **to adopt a preliminary number for the ending fund balance.**
SEN. STORY asked for a discussion and seeing none, the motion was approved unanimously.
SEN. STORY called for a legislator to sponsor the bill. REP. WAITSCHIES will sponsor the bill.

SEN. STORY wanted to thank the Committee for the two years of work that they did.

MEETING ADJOURNED
Meeting was adjourned at 6:00 p.m.

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