



State of Maryland Board of Revenue Estimates

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March 10, 2006

Honorable Robert L. Ehrlich, Jr.
Governor, State of Maryland
State House
Annapolis, MD 21401

Dear Governor Ehrlich:

In accordance with our policy of keeping you fully advised of developments concerning Maryland's revenue prospects, the Board of Revenue Estimates has reviewed the current estimates of general fund revenue in light of recent performance and the most recent economic data and developments. Based on our review, the Board submits to you revised current law general fund estimates of \$12.340 billion for fiscal year 2006 and \$12.930 billion for fiscal year 2007. This represents an increase in the fiscal year 2006 estimate of \$114.1 million and an increase in the fiscal year 2007 estimate of \$86.6 million, for a combined increase of \$200.7 million.

The State's economy is performing well. Employment growth for calendar year 2005 was 1.5%. The unemployment rate was steady throughout the year, and currently stands at 3.6%, just 30 basis points from the low reached in early 2000. Initial unemployment insurance claims declined over the course of the year, and are also at a level not seen since 2000. One of our major concerns in December was the impact of high energy prices, particularly in the event of a very cold winter. While prices for heating oil, natural gas and other energy sources have remained high, this winter has not been a cold one and the worst-case scenario did not come close to occurring.

Maryland's economy would be in even better position were it not for high energy prices, although as with much else over the past few years, consumers seem to have taken these in stride. The impact will be compounded, however, after July when caps on electricity prices for consumers are removed. BGE customers will face some of the largest increases in the country, expected to be over 70%. Customers of other utilities in the State will also have substantially higher electricity bills. BGE customers alone will have to come up with roughly \$900 million annually if these rate increases stand as proposed.

Another major risk to the forecast is the course of the housing market. Rising property values have benefitted both the economy and revenues (through income, sales and estate taxes, among others). In December it appeared that the housing market would slow by the end of calendar year 2006. Based on anecdotal information and, increasingly, actual data (January sales,

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according to the Maryland Association of Realtors, were at the lowest level since January 2001), it appears that the housing market is slowing more rapidly than anticipated. If a substantial slowdown has arrived, revenues are at risk both directly and indirectly, since housing has provided such a strong boost to the overall economy over the past few years. Despite these risks, we continue to expect Maryland's economy to perform as forecast in December, at a relatively healthy level of economic growth.

We are revising the individual income tax up by \$62.7 million for fiscal year 2006 and by \$30.6 million for fiscal year 2007. Growth in individual income tax revenues is now expected to slow from 11.5% in fiscal year 2005 to 9.6% in 2006, decelerating further to 6.1% growth in fiscal year 2007. Income tax withholding has grown 8.1% through February, well ahead of the 7.2% for the full year forecast in December. For withholding to grow by only 7.2% for the full fiscal year, it would have to slow appreciably to an unlikely 5.8% the remainder of the year. Based on year-to-date growth and an increasingly tight labor market which, coupled with strong business profitability, will result in an increasing share of income going to labor, we now project withholding will grow by 7.9% for the full fiscal year, an increase of \$48.2 million (roughly \$29.2 million in general fund revenue).

Estimated income tax payments for the fourth calendar quarter of 2005 were \$12.0 million higher than expected. Year-to-date growth is 20.2%, well above the 15.0% previously forecast for fiscal year 2006. While there are some factors which suggest a slowdown is in the offing—notably the impact of the slowing housing market on the profits of real estate speculators—other factors, including rising interest rates and a strong business environment, which is boosting income for self-employed individuals, suggest that healthy growth will continue longer than previously forecast. We are therefore revising the forecast for estimated income tax payments upwards by \$40.4 million (about \$24.4 million in general fund revenues).

Obviously, final income tax payments are minimal at this point—about 70% of the full year's payments are typically received in April. One of the few relevant pieces of information to come to light since our last forecast is fourth (calendar) quarter estimated payments, which are presumably made by taxpayers who have a good sense of their full year's tax liability. April final payments typically grow faster than fourth quarter estimated payments; the only exceptions over the past fifteen years are recessionary years or years affected by the 10% income tax reduction. Our prior forecast called for 14.6% growth in final payments for the full fiscal year. As a result of the 17.6% growth in estimated payments for the fourth quarter of 2005, we are revising final payments upward by \$45.2 million (about \$27.4 million general fund) for fiscal year 2006, to growth of 18.5%. We are leaving the estimate for fiscal year 2007 final payments unchanged, however, as it appears that the real estate market (which was largely responsible for the 40% growth in tax year 2004 final payments) is slowing more rapidly than previously anticipated. Final payments for fiscal year 2006 and especially for fiscal year 2007 are one of the larger risks in the forecast.

Income tax payments from fiduciaries are likely to finish the year well under prior expectations. Fiduciaries' estimated payments for tax year 2005 were flat. Given the safe harbor requirements, this implies substantial underpayment of taxes (which seems unlikely), a large drop

in liability, or roughly similar aggregate liability but incurred by different taxpayers using the prior year safe harbor. In any case, the prior estimate of 34.4% growth now appears overly optimistic. We are revising revenues from fiduciaries downward by \$30.2 million in fiscal year 2006 (\$18.3 million in general fund revenues). At this point in time, there is no reason to believe income tax refunds will vary greatly from our December forecast.

Corporate income tax revenues, among the most volatile of revenue sources, are growing strongly. Not strongly enough, however—due to much larger than expected refunds year-to-date, and with knowledge of a large amount of refunds which will shortly be paid out, we now expect that refunds of corporate income tax will be \$58.5 million higher than previously expected in fiscal year 2006. Based in part on continued strong performance of corporate profits—expected to have grown at or above 30% in calendar year 2005 when final figures are tallied—fiscal year 2006 gross receipts are forecast to be \$29.7 million higher than our December estimate. The net result of these changes is a \$21.9 million reduction in general fund revenues, although we are projecting growth of 18.1%. Our expectations for fiscal year 2007 are, however, now \$11.4 million higher than previously anticipated, as strong growth in corporate profits is expected to continue well into calendar year 2006 and one-time factors affecting refunds in fiscal year 2006 will not recur.

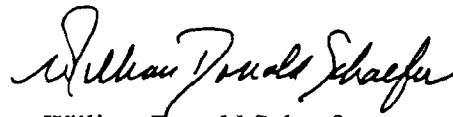
Estate tax revenues, the other very volatile revenue source, have performed far better than expected (about \$18.7 million) over the past three months. Interestingly, revenues from large estates—those with liabilities over \$500,000—are stagnant compared to last year. Estate tax revenues have grown 46% thus far this year, driven entirely by small estates. This growth is expected to continue as the most likely cause is the real estate market—a relatively modest home in many parts of the State along with several hundred thousand dollars of other assets can easily put an estate into a taxable position. Since estate taxes are generally paid nine months after death, realty is valued as of the date of death, and real estate prices continue to increase (although the number of transactions appears to be tailing off), revenue growth is expected to continue at about the current rate throughout fiscal year 2006. We have therefore increased the fiscal year 2006 estate tax estimate by \$35.7 million. Fiscal year 2007 revenues are projected to be \$24.7 million higher than previously, though this represents a 7.3% decline from the fiscal year 2006 estimate.

Sales tax revenues are currently \$5.5 million higher than our previous estimate. Unsurprisingly, construction and utility-related revenues are growing in double-digits (10.2% and 12.0% year-to-date, respectively). Revenues from capital goods are up 6.0%, while revenues from consumer expenditures have grown by 5.8%. All told, sales tax revenues are up 7.3% through February. Growth over the remainder of the fiscal year would have to drop more than two percentage points to meet the December forecast, a slowdown which seems implausible. We have therefore increased the fiscal year 2006 estimate by \$19.7 million, for full-year growth of 7.1%. We have not adjusted the fiscal year 2007 forecast in recognition of the substantial impending increases in residential electricity costs, which are likely to redirect a large amount of spending that otherwise would have gone towards taxable goods.

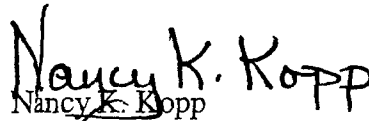
We have adjusted several other revenue sources to reflect year-to-date performance, including court revenues and interest earnings. Remaining revenue sources are performing at or above expectations. Several, including the lottery and tobacco tax revenues, appear likely to exceed the December estimates, but we are not confident enough about the outlook to revise them upwards at this time.

We believe that Maryland's economy is fundamentally sound and the risks generally remain on the upside, although we continue to be concerned about the effect of high energy prices on the national economy and consumer spending and the dynamics of the housing market. To the extent these risks are realized, however, they would primarily affect fiscal year 2007 revenues. We will keep you informed of any major developments as they occur.

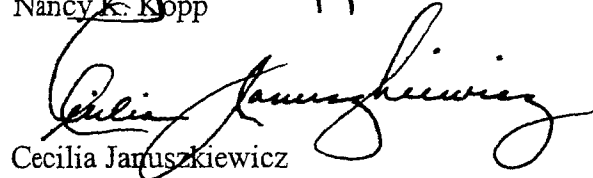
Sincerely,



William Donald Schaefer



Nancy K. Kopp



Cecilia Januskiewicz

Maryland General Fund Revenues
Fiscal Years 2005 - 2007
 \$ in thousands

	FY 2006					FY 2007			
	FY 2005 Actual	December Estimate	March Estimate	Difference	% Growth	December Estimate	March Estimate	Difference	% Growth
INCOME TAXES									
Individual Corporations ¹	5,660,614	6,144,059	6,206,781	62,722	9.6%	6,557,285	6,587,897	30,612	6.1%
	<u>512,237</u>	<u>626,635</u>	<u>604,737</u>	<u>(21,898)</u>	<u>18.1%</u>	<u>674,568</u>	<u>685,948</u>	<u>11,380</u>	<u>13.4%</u>
Total	6,172,851	6,770,694	6,811,518	40,824	10.3%	7,231,853	7,273,845	41,992	6.8%
SALES AND USE TAXES									
	3,129,352	3,330,910	3,350,608	19,698	7.1%	3,502,079	3,502,079	-	4.5%
STATE LOTTERY RECEIPTS									
	455,863	471,338	471,338	-	3.4%	483,658	483,658	-	2.6%
OTHER REVENUES									
Business Franchise Taxes	197,907	200,717	200,717	-	1.4%	202,699	202,699	-	1.0%
Tax on Insurance Companies	268,912	265,742	265,742	-	-1.2%	273,740	273,740	-	3.0%
Death Taxes	183,115	210,257	245,937	35,680	34.3%	203,210	227,958	24,748	-7.3%
Tobacco Tax	276,044	278,176	278,176	-	0.8%	279,172	279,172	-	0.4%
Alcoholic Beverages Excises	27,341	27,730	27,730	-	1.4%	28,223	28,223	-	1.8%
Motor Vehicle Fuel Tax	13,159	13,332	13,332	-	1.3%	13,747	13,747	-	3.1%
District Courts	87,408	89,365	92,971	3,606	6.4%	97,872	101,516	3,644	9.2%
Clerks of Court	55,465	58,217	51,777	(6,440)	-6.6%	52,773	46,910	(5,863)	-9.4%
Hospital Patient Recoveries	85,139	83,475	83,475	-	-2.0%	83,938	83,938	-	0.6%
Interest on Investments	64,397	113,274	133,976	20,702	108.0%	95,556	117,631	22,075	-12.2%
Miscellaneous	<u>377,713</u>	<u>291,827</u>	<u>291,827</u>	<u>-</u>	<u>-22.7%</u>	<u>294,726</u>	<u>294,726</u>	<u>-</u>	<u>1.0%</u>
Total	<u>1,636,601</u>	<u>1,632,112</u>	<u>1,685,660</u>	<u>53,548</u>	<u>3.0%</u>	<u>1,625,656</u>	<u>1,670,260</u>	<u>44,604</u>	<u>-0.9%</u>
TOTAL CURRENT REVENUES									
	11,394,669	12,205,054	12,319,124	114,070	8.1%	12,843,246	12,929,842	86,596	5.0%
Extraordinary Revenues ²	<u>153,365</u>	<u>20,393</u>	<u>20,393</u>	<u>-</u>	<u>N/A</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>N/A</u>
GRAND TOTAL									
	11,548,033	12,225,447	12,339,517	114,070	6.9%	12,843,246	12,929,842	86,596	4.8%

¹ Fiscal year 2005 corporate income tax receipts do not include \$151.0 million from the legislatively-mandated holding company settlement; this amount is included in extraordinary revenues, as are refunds associated with that settlement program. For fiscal year 2006, corporate receipts exclude the \$26.8 million MCI settlement (\$20.4 million in general funds); this amount has also been included as extraordinary revenues.

² Extraordinary revenues include the holding company settlement and certain miscellaneous transfers in fiscal year 2005, and the MCI settlement in fiscal year 2006.