COMMONWEALTH of VIRGINIA

Office of the Governor

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MEMORANDUM

TO: The Honorable Timothy M. Kaine

THROUGH: The Honorable William H. Leighty

FROM: Jody M. Wagner

SUBJECT: January Revenue Data

This month's revenue letter incorporates the revised general fund revenue forecast on which the introduced budget is based. It reflects the deliberations of the Governor's Advisory Board of Economists and the Advisory Council on Revenue Estimates, as well as policy actions recommended in the Governor's introduced budget. With the revisions, projected growth in general fund revenue for fiscal year 2006 is 6.1 percent. Net of tax policy changes, economics-based revenue growth in fiscal year 2006 is projected to be 8.4 percent.

January is a significant month for revenue collections. Individual estimated payments, sales taxes on December sales, and corporate income payments from large retailers are due. Total general fund revenue collections grew 10.5 percent in January. Most of the January revenue growth was due to strong individual nonwithholding payments and sales tax collections. Through January, revenues have grown 11.2 percent over the same period last year.

The Department of Taxation (TAX) continues its conversion process to the new Integrated Revenue Management System (IRMS). The conversion has resulted in a controlled production of individual and corporate extension returns processed during the conversion period. As the IRMS system moves toward full production, the backlog of refunds continues to reduce, and revenue growth is beginning to more closely reflect the underlying economic activity.

National Economic Indicators

Current indicators depict a slowly growing national economy heading into 2006.

- Real GDP grew 1.1 percent in the fourth quarter, significantly slower than third quarter growth of 4.1 percent. In 2005, real GDP grew 3.5 percent compared with 4.2 percent for calendar year 2004.
- Payroll employment added 193,000 jobs in January, far below expectations. However, November and December's gains were revised upward.
- Initial claims for unemployment fell to 273,000 during the last week of January. The four-week moving average fell to 284,250 – the lowest average since 2000. This level of claims is consistent with a labor market expansion.
- The Conference Board index of leading indicators rose 0.1 percent in December. Six of the ten components contributed positively to the index. The current reading indicates economic growth should continue in the near

term.

- With falling energy prices, the Consumer Price Index fell 0.1 percent in December. Core inflation rose 0.2 percent for the month, bringing the annual rate of core inflation to 2.2 percent.
- The Conference Board's index of consumer confidence increased to 106.3 in January, its third consecutive gain.
- The manufacturing sector continues to expand; however, growth is slowing. Although the Institute of Supply Management index fell to 54.8 in January, it continues to depict a growing manufacturing sector.
- As expected, the Federal Reserve raised the federal funds rate another 25 basis points to 4.5 percent in January.

Virginia Economy

In Virginia, payroll employment grew by 1.1 percent in December compared with the same month last year – about where it has been since last May. In Northern Virginia, payrolls grew by 3.0 percent. In Richmond-Petersburg jobs grew by 2.7 percent, followed by the western MSAs with 2.2 percent, and Hampton Roads with 1.6 percent growth.

The Virginia Leading Index rose by 1.2 percent in December after falling 1.5 percent in November. All four components (Virginia auto registrations, Virginia single-family building permits, Virginia initial unemployment claims, and the U.S. Leading Index) contributed to the increase. The indexes in eight metropolitan areas of the state increased in December, while Richmond's was unchanged and Charlottesville and Winchester registered declines.

January Revenue Collections

January is a significant month for revenue collections. Individual estimated payments, sales taxes on December sales, and corporate income payments from large retailers are due. Total general fund revenue collections grew 10.5 percent in January. Most of the January revenue growth was due to strong individual nonwithholding payments and sales tax collections. Through January, revenues have grown 11.2 percent over the same period last year.

Individual Income Tax Withholding (57% of general fund revenues): Collections of payroll withholding taxes grew 5.2 percent in January. Year-to-date withholding growth is 5.9 percent -- below the projection of 6.9 percent growth for the fiscal year.

Individual Income Tax Nonwithholding (14% of general fund revenues): Collections of nonwithholding payments were up 21.4 percent for the month. Collections of the fourth quarterly estimated payment due January 15, reflecting December and January receipts, were up 22 percent. Average check size increased about 25 percent, with about the same number of filers as there were in fiscal year 2005.

Year-to-date collections of nonwithholding are up 19.1 percent -- ahead of the estimate of 13.2 percent growth.

Individual Income Tax Refunds: This month, TAX issued $35.8 million in refunds compared with $36.7 million in January of last year. Fiscal year-to-date, $148.8 million in refunds have been issued compared to $205.6 million in the same period last year.

TAX continues to be in a controlled production mode for extension returns processed during its conversion to IRMS, which has resulted in fewer than normal individual refunds being processed. This has the effect of temporarily boosting apparent growth in individual income tax collections. Processing of individual refunds should increase in February as the tax filing season gets underway.

Sales Tax (22% of general fund revenues): Collections of sales and use taxes, representing December sales, grew 7.9 percent in January. Adjusting for the effects of tax relief on food, growth was 15.1 percent for the month. Year-to-date growth stands at 5.2 percent through January, ahead of the estimate of a 4.6 percent decline. Collections are expected to remain ahead of forecast until June when the reduced Accelerated Sales Tax program reduces collections by $200.1 million.

February collections will reflect post-holiday sales and the redemption of gift cards, completing the picture for the holiday season.

Corporate Income Tax (4% of general fund revenues): Corporate profits and collections of corporate income taxes have hit all-time highs over the last year. Corporate income tax receipts grew 28.1 percent in January. In January of last year, year-to-date growth in this source stood at 80.1 percent, the highest growth in over 20 years. This year, collections in this source have grown 85.2 percent over the same period last year.

Although underlying growth in this source is very strong, it is also likely overstated to some degree.

As with individual income tax collections, controlled production in the processing of extension returns has meant that fewer than normal extension returns are being fully processed. Last year at this time, $89.5 million in corporate refunds had been issued. This year-to-date, about $60 million in corporate refunds have been issued.

Other Revenue Sources

The following table provides data on January collections for other revenue sources:

	Year-to-Date	Required to Meet Estimate
Insurance Premiums Taxes (3% GF revenues)	-0.4%	5.1%
ABC Taxes (1.0% GF revenues)	5.2%	-0.5%
Public Service Corporations (0.6% GF revenues)	7.5%	2.6%
Interest Income (0.7% GF revenues)*	31.9%	17.3%

*Interest income for the October-December quarter attributable to nongeneral funds was transferred this month resulting in negative interest income for the general fund.

All Other Revenue: All Other Revenue grew by 17.9 percent in January -- $98.8 million compared with $83.7 million in January of last year. Solid growth in the largest component of all other revenue – wills, suits, deeds, and contract fees – helped to offset declines in many of the minor sources. Wills, suits, deeds, and contract fees (mostly recordation tax receipts) grew by 16.8 percent in January. Year-to-date growth stands at 37.6 percent. For the fiscal year, collections of All Other Revenue are 9.5 percent above fiscal year 2005, trailing the annual estimate of 10.4 percent growth.

Lottery Revenues: Lottery net profits increased 7.9 percent for the month. Overall, expenses were down 5.8 percent due to prize rates for Pick 3 being lower than statistically expected. With the strong sales growth so far, the year-to-date net income growth rate of 10.5 percent is well ahead of the projected 2.4 percent annual rate. The Lottery Department reports that comparisons to prior periods are greatly influenced by the size of advertised jackpots and prize expense rates that fluctuate with the "luck of the draw." Also, the kick-off of the North Carolina lottery later this fiscal year is expected to slow the overall sales growth. Both factors have been incorporated into the Lottery's revised revenue projections that was released in December.

Summary

This month's revenue letter incorporates the revised general fund revenue forecast on which the introduced budget is based. With these revisions, projected growth in general fund revenue for fiscal year 2006 is 6.1 percent. Net of tax policy changes, economics-based revenue growth in fiscal year 2006 is projected to be 8.4 percent.

Most of the January revenue growth was due to strong individual nonwithholding payments and sales tax collections. Through January, revenues have grown 11.2 percent over the same period last year.

This year, TAX's conversion to its new Integrated Revenue Management System (IRMS) has contributed to distortions in the collections data. Controlled production for individuals and corporations that filed extension returns has slowed the processing of refunds. As a result, revenue growth in these sources is over-stated. TAX continues to work these returns to insure taxpayers are not adversely affected by the conversion.