

COMPTROLLER  
*of* MARYLAND  
*Serving the People*

William Donald Schaefer  
*Comptroller*

David F. Roose  
*Director*  
*Bureau of Revenue Estimates*

August 25, 2005

To: Honorable William Donald Schaefer  
Honorable Nancy K. Kopp  
Secretary Cecilia Januszkiewicz

From: David F. Roose *DR*  
Director, Bureau of Revenue Estimates

Subject: Fiscal Year 2005 Revenues

General fund revenues totaled \$11.548 billion in fiscal year 2005, \$422.5 million over the estimates (3.7%). Growth in ongoing revenues was 11.3% over 2004, although baseline growth was approximately 9.7%. It should be noted that the rate of growth, particularly in the income taxes, the estate tax, and interest income, is not likely to be sustainable beyond the near term. All major revenue sources finished at or above the forecast; only insurance premium taxes and the motor vehicle fuel tax were below the estimates.

Individual income tax revenue totaled \$5.661 billion, an increase of 11.5%, and was \$245.0 million (4.3%) over the estimate. The income tax has finally exceeded the prior peak of \$5.133 billion reached in fiscal year 2001. Income tax withholding grew by 8.3% to \$8.557 billion, \$84.0 million (1.0%) above the estimate. The State's fairly steadily accelerating economy was the primary factor for the strong performance. Employment in July 2004 was only 0.9% above the levels of the prior July, but by June 2005 employment had grown 2.3% over the prior June. For the full fiscal year, employment grew 1.6%, double the rate of fiscal year 2004. Similarly, wage and salary income grew by 4.1% in the first quarter of the fiscal year and 7.4% in the third (the latest available data) for a 6.2% growth rate for the first three quarters—better than the 5.9% called for by the forecast over the same period.

Law changes provided an additional boost to withholding—fiscal year 2005 was the first full fiscal year for flat withholding, several large local income tax rate increases for tax year 2004 and withholding from real estate sales of nonresidents, and the nonresident local tax was effective for half of the fiscal year. Adjusting for the roughly \$140 million incremental impact of these changes leads to baseline withholding growth of about 6.6%, a substantial improvement over last year's 5.0% baseline growth. Withholding's better-than-expected performance accounted for about 20% of the \$245.0 million in unexpected general fund individual income tax revenues.

Nonwithheld individual income tax payments—estimated, fiduciary and final payments—outperformed the estimates substantially. Final and fiduciary payments were

particularly strong, both absolutely and relative to the estimates. Final income tax payments finished the year \$198.4 million (20.7%) over the estimate, having grown by 40.5% to \$1.158 billion, and fiduciary payments finished \$32.3 million (48.7%) over the estimate, growing by almost 150% to \$98.6 million. Estimated income tax payments grew by a more sedate 17.3% to \$1.260 billion, and were only \$26.1 million (2.1%) greater than expectations. All together, these revenue sources were \$256.8 million over the estimates, contributing roughly 60% of the \$244.5 million general fund individual income tax surplus. Refunds were \$81.8 million (4.6%) under the estimate, contributing the remaining 20% of the unexpected revenue.

As I have indicated to you previously, much of the strong performance from these components of the individual income tax results from the real estate market. Data from the State Department of Assessments and Taxation show that the rapid appreciation of prices over the past four years has resulted in large increases in the number of sales of both owner-occupied residential property subject to tax (those with a capital gain of more than \$250,000 for single filers and \$500,000 for joint filers) and non-owner-occupied residential property. As one example, the number of homes selling for over \$1 million grew by over 300% from 2001 to 2004, and by almost 100% in 2004 alone. We are continuing our analysis of the data, and this issue more generally, but at present we attribute over one-third of the unexpected nonwithheld revenue to capital gains from the real estate market. This revenue is likely to continue for much or all of fiscal year 2006, and perhaps even longer, but it will trail off as the number of residential sales will decline at some point even if housing prices stay at current high levels.

There are several other factors that have played a part in the strong growth of nonwithheld income tax revenue. Tax year 2004 was the first full year of the federal 15% income tax rate for long-term capital gains; there is anecdotal information that the rate reduction coupled with no further prospect of tax cuts and two relatively good years for the stock market may have spurred investors to lock in gains. Given this lower rate, it is also possible that many investors in 401(k)s and other tax-deferred investments have shifted new investments from those accounts to taxable investments for the greater flexibility (which would have resulted in higher final payments if withholding was not adjusted). Additionally, there were probably many investors whose capital loss carryforwards from 2001 and 2002 were completely or nearly exhausted, resulting in a much smaller amount to be set against capital gains in 2004. Unfortunately, hard data on these issues do not exist, but they have no doubt all played some role in the striking performance of the individual income tax in tax year 2004.

Corporate income tax revenue posted a record year, with net general fund collections reaching \$663.3 million. Of that amount, \$151.0 million resulted from the legislatively-mandated Delaware holding company settlement, and is shown on the accompanying table as extraordinary revenue. Even excluding these revenues, ongoing revenues of \$512.2 million bested the previous peak in fiscal year 2001 by 37%. The impact of the holding company addback, implemented in the third quarter of calendar year 2004 but applying to all of tax year 2004, is estimated to be about \$60 million for fiscal year 2005. Through mid-August, fewer than several dozen corporate

returns for 2004 showing the addback have been filed. The 25,000 total corporate returns filed, however, represent only \$40 million of tax liability (well under 10% of total expected liability), so no conclusions as to the revenue effect of the addback can yet be drawn. After the September (extension) deadline for calendar year filers, we should have an indication as to the magnitude of the impact, but it won't be until after the March 2006 revenue revisions that we have all of the tax returns for tax year 2004 and are able to definitively determine the revenue effect of the addback.

Almost no matter the impact of the addback on revenues, the growth of 55.9% (excluding settlement revenues) indicates very strong baseline performance. Over the two calendar years 2003 and 2004, national corporate profits grew by 37.9%, the best showing since 1987/88. Given the vagaries of tax year deadlines, filing extensions, carryforward losses and apportionment, national corporate profit data do not directly relate to Maryland corporate income tax revenues. Maryland's receipts are in line with federal receipts, which have grown by 41.1% for the ten months of federal fiscal year 2005 through July; given both the implementation of the addback and Maryland's service-oriented economy, it is not surprising to see our corporate revenues growing faster than federal revenues.

Sales and use tax revenue posted its second strong year in a row, growing by 7.1% to \$3.129 billion and exceeding the estimate by \$20.1 million (0.6%). Despite soaring energy prices, the consumer segment of the sales tax, two-thirds of the total, grew by 5.2%. This growth is modest compared to last year's 7.3% growth, but it is stronger than the 10-year average growth rate of 4.8%. Low interest rates and the booming housing market lent indirect support to consumer spending through continued mortgage refinancing and the need of home buyers to furnish and decorate their new purchases. The primary driver of growth, however, was the strengthening labor market which resulted in wage and salary growth of over 7% in the middle two quarters of the fiscal year—the best quarterly growth in wage and salary income since the last half of 2000. The consumer component of the sales tax was \$19.6 million over the estimate (0.9%), nearly the entire overage of sales tax revenues.

The housing market directly supported the growth of the construction segment of the sales tax, the second largest component. Construction-related activity generated \$503.3 million in revenue, growing an impressive 13.0%, the second-strongest year in the last 20, following last year's 15.9% growth. Recent interest rate hikes by the Federal Reserve Board have not noticeably affected mortgage rates (the composite rate has hovered between 5.4% and 5.9% since the start of 2003), and the strong appreciation in Maryland has led to robust construction activity. Performance was uneven and weaker in this sales tax category in the second half of the fiscal year, with three months growing at a single-digit rate (compared to one in the first six months); the first half of the year averaged 15.0% growth, while the second half averaged 11.0%—strong, to be sure, but a deceleration perhaps of some concern.

Sales tax revenue from utilities grew by 10.8% to \$263.7 million, \$293,000 (0.1%) under the estimate. The double-digit growth was the strongest since 1999-2001

during the unsustainable boom in telecommunications infrastructure investment. While such investment has rebounded and growth in the cellular phone market continues, part of this growth is no doubt due to the increase in energy prices, as industrial and commercial users pay sales tax on their utility bills. Revenues from capital goods reached \$276.7 million, growing by 7.8% and exceeding the forecast by \$2.8 million (1.0%). The generally strong economy and continued spending on computer hardware and particularly software drove growth; the expiration of bonus depreciation for federal income tax purposes may have played a role as well. Assessments and refunds both declined by just over 20%, and their differences from the estimates nearly offset each other. Revenues from short-term vehicle rentals distributed to the Transportation Trust Fund were \$24.3 million, 1.6% over the estimate of \$23.9 million.

General fund lottery revenues reached a record \$455.9 million, growth of 4.5% over fiscal year 2004 levels. Revenues exceeded the estimates by \$9.7 million (2.1%). Sales grew by 6.5%. Keno led the way in sales at \$416.5 million, followed by instant tickets (\$391.0 million) and Pick 3 (\$296.1 million). In terms of revenue, Pick 3 narrowly edged out Keno at \$125.7 million. Relative to the estimates, Mega Millions performed the best, exceeding its estimate by \$10.8 million. Sales were just under \$100 million, \$24.0 million over the estimate. Rather than dropping back from record-high sales in fiscal year 2004, sales grew by 10.4% despite the absence of large jackpots. Pick 4 was \$3.1 million over its estimate, largely also a result of higher than expected sales. The two largest games, Keno and instant tickets were under their estimates by the greatest amounts. Keno revenues were \$4.2 million under the estimate due to lower sales than expected and slightly higher administrative expenses; although instant ticket sales were \$9.3 million higher than forecast, revenues were \$2.0 million under the estimate due to higher than expected prize payouts and administrative expenses.

Business franchise taxes were \$3.0 million (1.5%) over the estimates at \$197.9 million as corporate filing fees, which were raised from \$100 annually to \$300 annually last year, generated \$6.3 million more than expected. Insurance premium taxes fell \$5.2 million (1.9%) short of the estimate despite growing 3.4% to \$260.0 million.

Death taxes exceeded the estimates by \$18.8 million (10.3%), with the estate tax resulting in almost the entire overage. Estate tax revenues grew by 23.5% to \$137.5 million, \$18.7 million higher than the estimate. Most of that difference came from large estates, as the 24 estates with \$500,000 to \$1 million liabilities were \$8.4 million over their estimate and the 23 estates with liabilities greater than \$1 million were \$7.5 million over their estimate. The number of these smaller large estates almost doubled from last year, while there was actually one fewer of the largest large estates, though the average liability was obviously higher (21.5% higher, in fact). The collateral inheritance tax was \$24,100 below the estimate (0.1%) at \$45.1 million, while the repealed direct inheritance tax was \$114,600 over the estimate (31.8%). Residual revenues for the direct inheritance tax will continue for some time, though revenues are minimal—\$474,600 in fiscal year 2005.

Tobacco tax revenues were \$5.8 million over the estimates as cigarette tax

revenue actually increased by 1.1% rather than declining by 1.1% as called for by the estimates. Cigarette tax revenues reached \$267.9 million, \$5.6 million ahead of the estimate. Revenues from other tobacco products were \$8.2 million, \$232,600 ahead of the forecast and 11.2% ahead of last year. Alcoholic beverage excise tax revenues were \$384,200 (1.4%) above the estimates at \$27.3 million; revenues from distilled spirits and wine were more than 2% above the estimates while revenues from beer were 1.0% below the estimates. Revenues from the motor vehicle fuel tax were 1.2% below the estimate despite growing 1.0%. High oil prices have taken their toll, although the impact on the general fund is minimal since revenues are only \$13.2 million. The impact on the Transportation Trust Fund was more significant.

Court revenues exceeded the estimates by \$11.3 million. Revenues from the clerks of court declined by 2.4% but were \$8.2 million (14.7%) over the estimate. Home purchases and mortgage refinancing activity was higher than expected as mortgage rates remained subdued in the face of interest rate increases by the Federal Reserve. Revenues from the District Court were \$3.1 million (3.6%) above expectations. Interest income for the general fund grew by 142% to \$64.4 million, and was \$13.6 million (21.0%) above the forecast as a result of both higher than expected balances and interest rates.

Miscellaneous revenues were \$37.8 million (10.0%) over the estimates, reaching \$377.7 million. Revenues from unclaimed property continued to exceed expectations, largely from continuing demutualization of insurance companies, as have those from uninsured motorist penalty fees. Together, these two revenue sources were \$20.7 million over the estimates. Excluding hospital patient recoveries, which were \$1.1 million (1.3%) over the estimate, revenues from the Department of Health and Mental Hygiene were \$8.3 million higher than expected. Of that amount, \$6.1 million was interest from a bank account that belonged to a former contractor providing mental health services; when the contract was over, the account was closed and the interest was reverted to the general fund. General fund revenues from the Maryland State Police were about \$8.5 million over the estimate as a result of a special fund revenue transfer.

Fundamental revenue trends are favorable, and will be reflected in the next round of forecasts. While levels of revenue will certainly be adjusted upwards to account for these factors, it is possible that, after the Revenue Monitoring Committee has analyzed fiscal year 2005 results and new economic forecasts in detail, the preliminary forecast for fiscal year 2006 and especially 2007 will show lower rates of growth, especially in the income taxes. We will deliver this forecast to you in mid-September, but if you have any questions in the meantime, please do not hesitate to contact me.



## Actual and Estimated General Fund Revenue Fiscal Year 2005

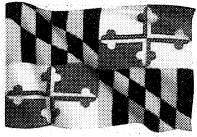
	Fiscal Year 2005		Fiscal Year 2004	
	Actual	Estimated <sup>1</sup>	Difference from Estimate	
			\$	%
			Actual	Growth FY 04-FY 05
			\$	%
<b>INCOME TAXES</b>				
Individual Corporations <sup>2</sup>	5,660,614,331	5,415,632,000	244,982,331	4.3%
	512,236,928	450,867,317	61,369,611	12.0%
Total	6,172,851,259	5,866,499,317	306,351,942	5.0%
<b>SALES AND USE TAXES</b>	3,129,352,440	3,109,302,000	20,050,440	0.6%
<b>STATE LOTTERY RECEIPTS</b>	455,863,364	446,195,000	9,668,364	2.1%
<b>OTHER REVENUES</b>				
Business Franchise Taxes	197,907,370	194,918,000	2,989,370	1.5%
Tax on Insurance Companies	268,912,495	274,072,000	(5,159,505)	-1.9%
Death Taxes	183,115,297	164,281,000	18,834,297	10.3%
Tobacco Tax	276,044,215	270,222,000	5,822,215	2.1%
Alcoholic Beverages Excises	27,341,243	26,957,000	384,243	1.4%
Motor Vehicle Fuel Tax	13,159,119	13,319,000	(159,881)	-1.2%
District Courts	87,407,950	84,299,000	3,108,950	3.6%
Clerks of Court	55,464,938	47,306,000	8,158,938	14.7%
Hospital Patient Recoveries	85,139,015	84,035,000	1,104,015	1.3%
Interest on Investments	64,397,240	50,846,000	13,551,240	21.0%
Miscellaneous	377,712,555	339,885,682	37,826,873	10.0%
Total	1,636,601,438	1,550,140,682	86,460,756	5.3%
<b>TOTAL CURRENT REVENUES</b>	11,394,668,500	10,972,136,999	422,531,501	3.7%
Extraordinary Revenues <sup>2</sup>	153,364,536	153,364,536	-	0.0%
<b>GRAND TOTAL</b>	11,548,033,036	11,125,501,535	422,531,501	3.7%
			1,476,400,749	10.9%
			10,240,702,240	11.3%
			(36,378,036)	-521.6%
			1,343,708,832	13.2%

<sup>1</sup> The fiscal year 2006 budget increased 2005 revenue estimates by \$2.3 million; the estimate for miscellaneous revenues has been adjusted accordingly.

<sup>2</sup> Fiscal year 2005 corporate income tax receipts do not include \$151.0 million from the legislatively-mandated Delaware holding company settlement; these revenues are included as extraordinary revenues.

<sup>3</sup> Extraordinary revenues include the Delaware holding company settlement receipts in fiscal year 2005, and a GAAP transfer and several miscellaneous transfers in fiscal year 2004.

There were additional budgeted transfers from other funds into the general fund totaling \$375.9 million in fiscal year 2004 and \$474.6 million in fiscal year 2005.



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William Donald Schaefer  
*Comptroller*

John D. Kenney  
*Director*  
*General Accounting Division*

**Statutory Fund Balance**  
**June 30, 2005**

General Fund Balance, June 30, 2004 available for 2005 operations		\$ 452,658,406
2005 Estimated Revenues		11,125,501,535
Transfer from Revenue Stabilization Account		91,000,000
Transfer from special funds - prior session (see detail)		383,552,462
2005 General Fund Appropriations		
Appropriated by the 2004 General Assembly	\$ 11,195,406,487	
Deficiency appropriations - 2005 General Assembly	100,439,158	
Estimated agency reversions	<u>(20,000,000)</u>	
Subtotal Appropriations		<u>11,275,845,645</u>
Estimated 2005 General Fund Balance		\$ 776,866,758
Add:		
Actual Revenues in Excess of Estimates		422,531,501
Actual Reversions in Excess of Estimates:		12,034,779
Deduct:		
State Treasurer adjustment to decrease general fund cash		<u>(37,007,057)</u>
2005 General Fund Balance		\$ 1,174,425,981
Designated for 2006 Operations		<u>(571,143,511)</u>
Undesignated General Fund Balance, June 30, 2005		<u>\$ 603,282,470</u>

**State of Maryland**  
**Transfers to General Fund**  
**June 30, 2005**

**Transfers from special funds**

Transfer taxes	\$189,260,444
Local share of transportation revenues	102,440,128
Share of accelerated disbursement of unclaimed taxes	81,000,000
Central Collection Unit	4,500,000
State Use Industries	2,000,000
Homebuilders Registration Fund	500,000
Spinal Cord Injury Trust Fund	2,557,790
Various Health Department Boards	879,000
Racing Commission	415,100
	<u>\$383,552,462</u>