COMMONWEALTH OF VIRGINIA
Office of the Governor

Timothy M. Kaine
Governor

February 14, 2006

The Honorable John H. Chichester
Chairman
Senate Finance Committee
Room 626
General Assembly Building
Richmond, Virginia 23219

The Honorable Vincent F. Callahan, Jr.
Chairman
House Appropriations Committee
Room 947
General Assembly Building
Richmond, Virginia 23219

The Honorable Harry J. Parrish
Chairman
House Finance Committee
Room 504
General Assembly Building
Richmond, Virginia 23219

Gentlemen:

It is customary for the Governor to provide a mid-session update to the general fund revenue forecast on which the introduced budget was based. I am writing you to follow-up on our discussions this morning regarding the forecast revision.

There is limited economic data to compare to the economic outlook on which the official forecast was based. As a result, the forecast revision is based primarily on collection trends through January. A summary table of the mid-session revision to the forecast is attached as Attachment A.

The most significant general fund revenue source – individual withholding – is tracking slightly behind the levels assumed in December. The unusual growth we are seeing is limited largely to two of the most volatile revenue sources – corporate income and individual nonwithholding – which together account for about 17 percent of total general fund revenue. Because of their extreme volatility, we cannot assume that the extraordinary growth we are seeing in these sources will continue beyond FY07.

Individual Withholding Taxes: Through January, withholding tax collections grew at 5.9 percent, as compared to the forecasted 6.9 percent. To meet the original forecast, withholding would have to grow at 8.3 percent over the last five months of this fiscal year. As this is unlikely, growth for the year is now projected at 6.2 percent, $53 million below the December forecast. This is in line with more current economic data which shows employment growth slightly less than our previous projections. Furthermore, since slowing payroll growth will likely flow through to the next biennium, we have reduced the forecast in each of FY07 and FY08 by $53 million.

Individual Nonwithholding Taxes: Nonwithholding collections consist of four estimated payments and one final payment each fiscal year. Nonwithholding collections are normally correlated with strength in the financial markets. Growth in nonwithholding collections varies significantly from year to year, as shown on Attachment B.

Through January, nonwithholding collections were up 19.7 percent above last year. The forecast is being increased $84 million in FY06 and $30.0 million in FY07 to reflect strong collections through January and expectations for healthy growth in non-wage tax liability for tax years 2005 and 2006. We do not see any justification at this time for increasing the FY08 forecast.

Refunds: The refunds forecast is being revised downward, creating a $65.0 million gain to the general fund in FY06 and a $58 million gain in each of the next two years. This reflects lower refunds as the result of less overwithholding and strong growth in income that is not subject to withholding, such as interest and dividend income.

Corporate Income Taxes: The December forecast of a 17.1 percent increase for corporate income taxes in FY06 assumed continued healthy growth in this source. In January we adjusted the forecast upward by $53.1 million to reflect "money in the bank" through December 2005. We believe this extraordinary growth in corporate taxes will continue during the remainder of this fiscal year and into FY07. The revised forecast adds $76 million in corporate taxes in FY06 in addition to the $53.1 million added in January. We are also adding $35 million in FY07. Due to the historical volatility of corporate tax payments, as shown on Attachment C, we are not adding to the FY08 forecast.

Recordation Taxes: Recordation taxes are highly volatile, as shown on Attachment D. As you will recall, several business leaders representing the housing and mortgage industry at the GACRE meeting in November indicated that they anticipated a slow-down in the housing market. We are beginning to see the signs of that in 70 percent of Virginia housing market (Northern Virginia, Hampton Roads, and Richmond). Those areas are experiencing declines in pending home sales, with the most significant slowing in the high-priced region of Northern Virginia, where pending sales are down 25 percent in volume over the last four months. The drop in pending home sales is depicted on Attachment E.

Sales Tax: The sales tax forecast is being revised upward by $18 million in FY06 to reflect slightly stronger growth through January, the result of a solid holiday shopping season.

Other: Other minor sources have some modest adjustments to reflect Tax's controlled production conversion to the new accounting system, specifically interest on delinquent taxes and fines (-$25 million). In addition, interest earnings on state funds are expected to be slightly better than forecast in December ($8 million).

Summary of Revised Forecast. The mid-session revision to the revenue forecast adds $163.0 million of revenue, most in FY06. It is important to note that the largest portion of the increase is in sources which will drive additional deposits to the Revenue Stabilization Fund. With these forecast revisions, an estimated additional $102 million will need to be deposited to the Fund in FY08.

The increased revenues are good news. In the current fiscal year, we were cautious, but not conservative, in adjusting the revenue projections. Given the volatility of the revenue sources driving the increase, we believe that
a significant degree of caution is in order.

In the next two fiscal years, we were cautious because we face very real risks, including the effects of the proposed Federal budget for Federal FY07 (elimination of, or reduction in, funding for major programs important to Virginians), possible further declines in the housing market, possible continued spikes in energy prices that may hurt consumer spending and corporate profits, and potential effects of Virginia tax credit programs on future revenue collection.

I look forward to working with you during the remainder of this session as we complete the budget process.

Sincerely,

Timothy M. Kaine

TMK/jmw
Attachments

Attachment A

Mid-session Revenue Forecast

Summary of Changes from the Governor's Amendments

	Fiscal Year 06		Fiscal Year 07		Fiscal Year 08	
	$ Change	% Change	$ Change	% Change	$ Change	% Change
Withholding	$ (53.0)	-0.7%	$ (53.0)	-0.6%	$ (53.0)	-0.6%
Nonwithholding	84.0	3.6	30.0	1.2	0.0	-
Refunds	(65.0)	(5.0)	(58.0)	(4.2)	(58.0)	(4.0)
Net individual	96.0	1.1	35.0	0.4	5.0	0.0
Sales	18.0	0.6	0.0	-	0.0	-
Corporate *	76.0	9.8	35.0	4.7	0.0	-
Recordation	(49.0)	(6.3)	(36.0)	(5.5)	0.0	-
Insurance	0.0	-	0.0	-	0.0	-
All Other Revenue	(17.0)	(2.3)	0.0	-	0.0	-
Total	**$ 124.0**	**0.9%**	**$ 34.0**	**0.2%**	**$ 5.0**	**0.0%**

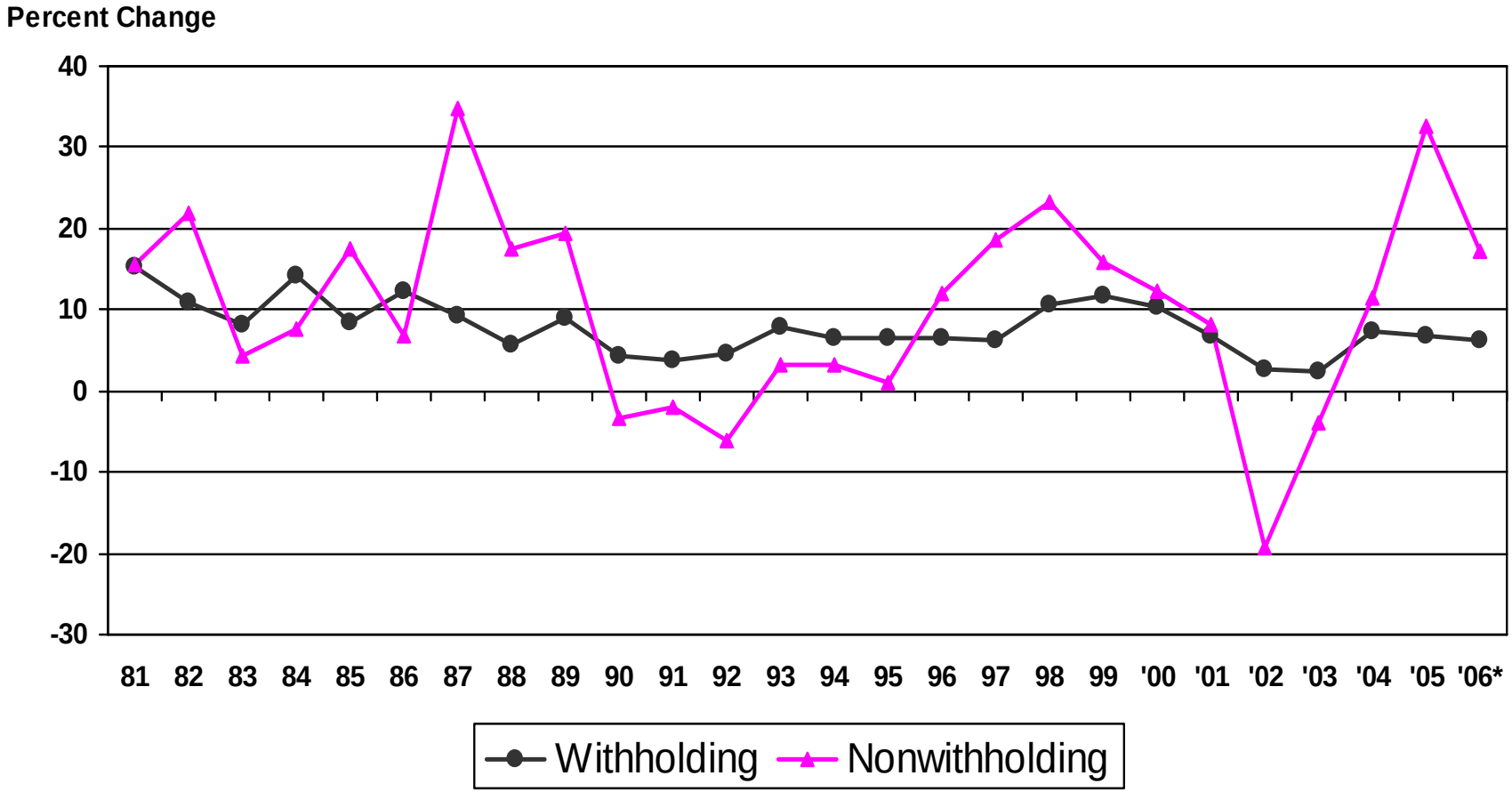
3-year Total **$ 163.0**

* Does not include the $53.1 million included in the Governor's Amendments.

Note: Revenue Stabilization Fund Deposit based on the FY06 revised forecast would increase by $102.0 million in FY08

Withholding and Nonwithholding

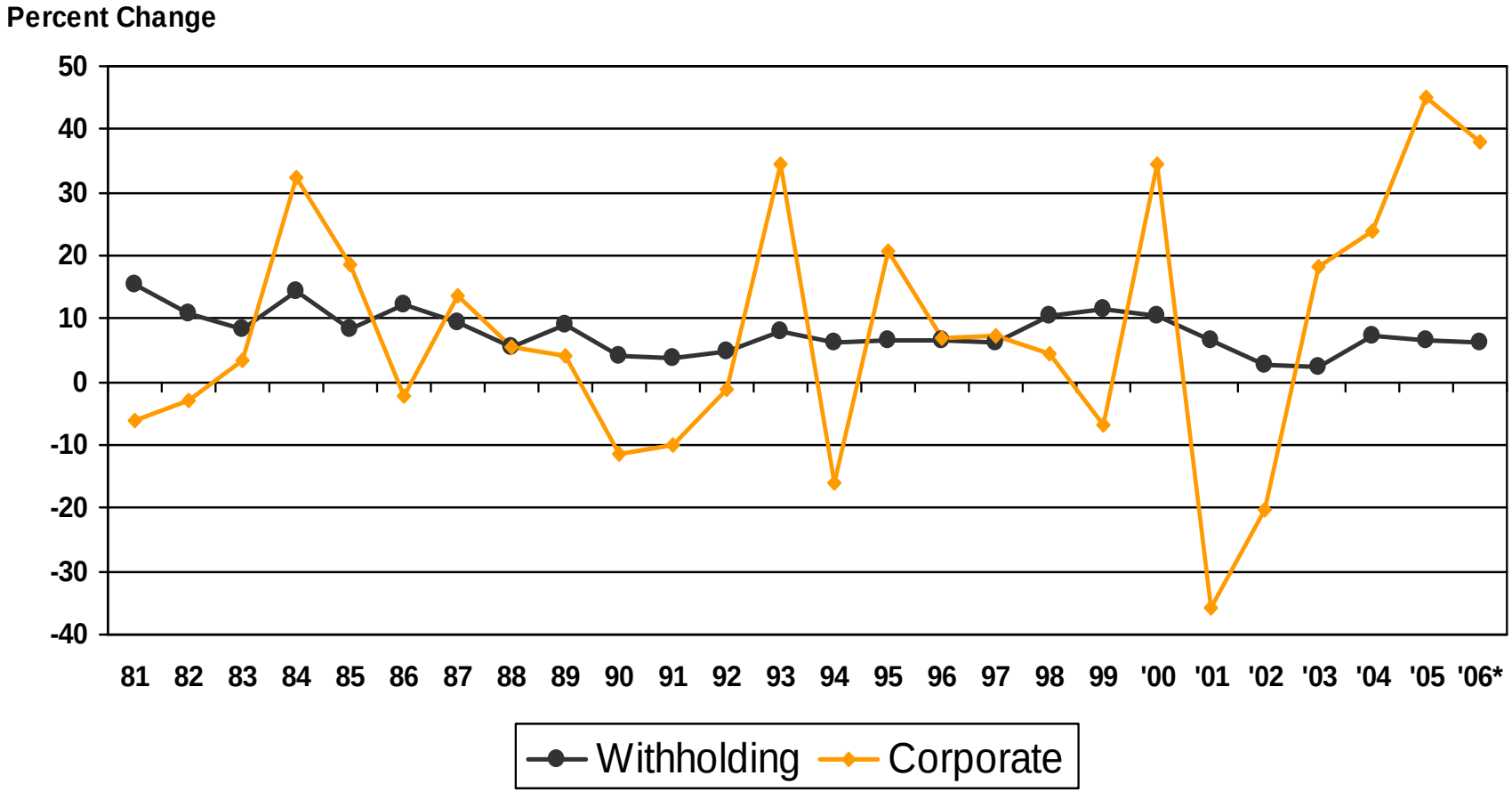
Fiscal Year Percent Change



* FY06 is forecast

Withholding and Corporate

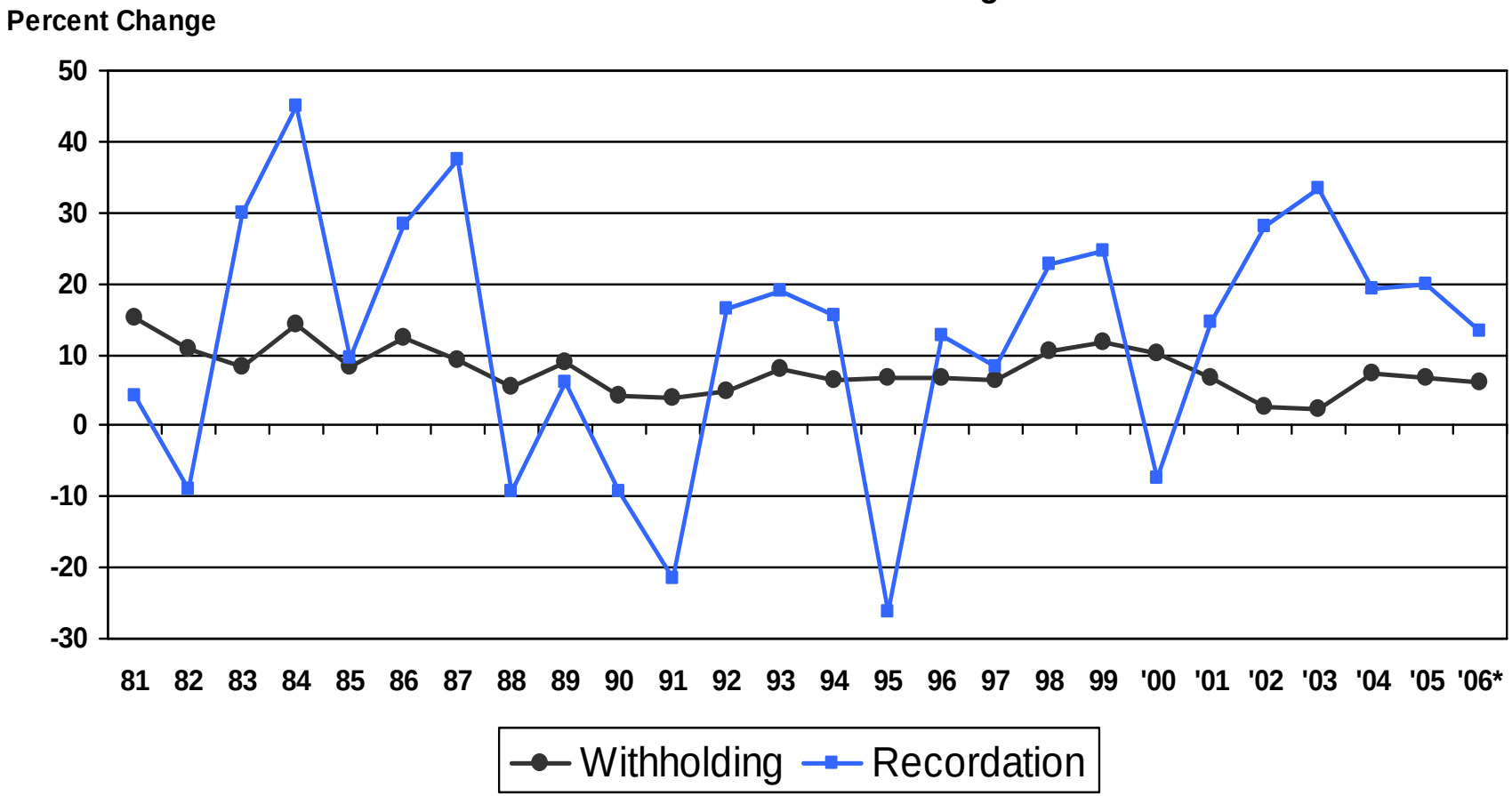
Fiscal Year Percent Change



* FY06 is forecast

Withholding and Recordation

Fiscal Year Percent Change



* FY06 is forecast

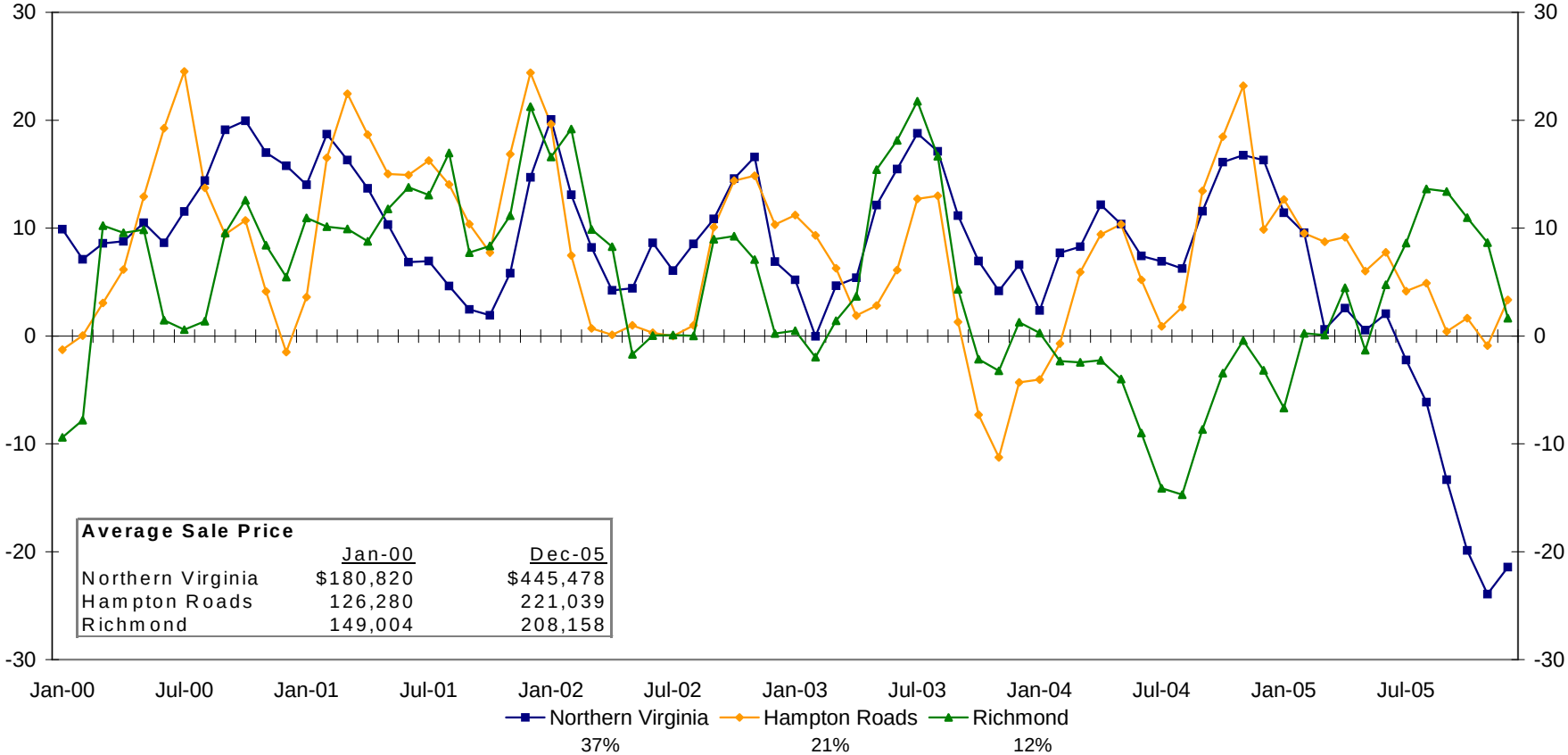
Note: Recordation growth rate removes the rate increase.

Attachment E

Pending Home Sales in Northern Virginia, Hampton Roads, and Richmond

Year-over-Year Percent Change

Seasonally-adjusted 3-month moving average



Average Sale Price

	Jan-00	Dec-05
Northern Virginia	$180,820	$445,478
Hampton Roads	126,280	221,039
Richmond	149,004	208,158