



COMMONWEALTH of VIRGINIA

Office of the Governor

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Memorandum

TO: The Honorable Mark R. Warner

THROUGH: The Honorable William H. Leighty

FROM: John M. Bennett

SUBJECT: August Revenue Data

August is not a significant month for revenue collections, with collections coming mainly from withholding payments, sales taxes, and other sources which have regular monthly collections. In addition, the month includes relatively small off-schedule payments in other sources.

Three non-economic factors significantly affected revenue collections in August, making this month's report more complex than usual to assess:

- 1) In August, the Department of Taxation (TAX) began conversion to a new Integrated Revenue Management System (IRMS) which will be the hub of all its transaction and revenue processing. During the transition, each system module is implemented in a controlled production mode, so that defects can be diagnosed and corrected as they occur. During this period, very few income tax refunds are processed. Revenue totals for some sources are estimates prepared by TAX staff. Total revenues listed are correct, but some minor reconciliation in some sources may be necessary later.
- 2) This August had one additional deposit day compared to last year, and the additional day was a Wednesday – meaning that August had five rather than four Wednesdays. Wednesday is the due date for all employers to submit withholding payments to the Federal government and to states like Virginia that follow the federal schedule. Companies which have Friday payroll dates also normally settle EFT payments on Wednesday. Both factors make Wednesday a significant collections day for withholding, and pushed withholding collections in August higher than they would have been otherwise. Over the year, these timing anomalies will balance out.
- 3) Tax policy changes enacted over the last two sessions are reflected in this August's revenue collections, but were not in effect last August, distorting the monthly and year-to-date comparisons. Those changes include rate increases on retail sales and recordation taxes, and the rate decrease on food for home consumption.

This month's revenue report displays in the first column the forecast on which the Appropriation Act (Chapter 951) was based. The last column reflects the percent annual growth required by the estimate when compared to actual fiscal year 2005 collections. Unusually strong revenue growth in FY 2005 artificially reduces required growth rates for FY 2006.

These growth rates represent growth needed to meet the amounts budgeted, and do not represent a revised forecast. Some of FY 2005's strong revenue performance will ripple forward into FY 2006, but revised estimates for FY 2006 will not be finalized until the fall forecasting process is complete.

Total general fund revenue collections grew 23.9 percent in August, and year-to date growth stands at 17.0 percent. If the unusual factors cited above are taken out, then economics-based revenue increased 7.9 percent for the month and year-to-date economics-based revenue growth stands at 6.7 percent.

National Economic Indicators

National economic indicators prior to Hurricane Katrina continued to depict an expanding economy.

- Real GDP grew 3.3 percent in the second quarter, down from 3.8 percent in the first quarter.
- Employers added 169,000 jobs to payrolls in August, and the employment gain in July was revised upward to 242,000. Employment grew in most sectors in August, with only manufacturing and social services losing jobs.
- Initial claims for unemployment fell slightly by 1,000 to 319,000 during the first week of September. This was the first week that Katrina affected claims, and about 10,000 of initial claims are attributed to the storm. The four-week moving average of 319,000 is consistent with an improving labor market.
- The manufacturing sector continues to expand, but at a slower pace. In August, the Institute of Supply Management index fell three points to 53.6.
- The Conference Board's index of consumer confidence rose in August to 105.6. Both components increased, although the present situation index accounted for most of the growth.
- The Conference Board's index of leading indicators rose 0.1 percent in July, with six of its ten components increasing.
- The consumer price index rose 0.5 percent in July, driven by a 6.1 percent increase in gas prices. Core inflation rose 0.1 percent for the month.
- The Federal Reserve raised the federal funds rate at its August meeting to 3.5 percent, the tenth consecutive rate increase.

Given the enormity of the damage and the unprecedented level of likely aid to the affected area, Katrina's impact on the national economy is difficult to predict. Most economists expect Katrina's effects to slow GDP growth from .5 to 1.0 percent in the near term, but to boost it by a similar amount when rebuilding efforts begin in earnest. Many economic indicators are also likely to vary significantly from month to month. Some economists have predicted, for example, that national employment could temporarily drop by over 500,000 jobs. The substantial level of required federal aid also raises questions about the level of future federal appropriations in most other areas.

Virginia Economy

In Virginia, payroll employment grew by 1.44 percent in July compared with the same month last year. Since January, payroll employment growth has gradually moderated from 2.8 percent to about 1.4 percent, where it has stayed since May.

In the Northern Virginia and Richmond-Petersburg MSAs, payrolls grew by 3.1 percent, followed by the western MSAs with 2.3 percent, and Hampton Roads with 1.1 percent growth.

The Virginia Leading Index was flat in July after a 1.8 percent increase in June. Negative contributions by the auto registrations and initial claims components offset increases in the U.S. Leading Index and building permits.

August Revenue Collections

Total general fund revenue collections grew 23.9 percent in August. Most of the August revenue growth was due to strength in payroll withholding, sales tax receipts, and recordation taxes.

Revenue growth was boosted by three unusual factors: (1) an additional deposit day; (2) comparison to a month last year when HB 5018's tax policy changes were not in effect; and (3) the transition to a new computer system at the Tax Department, which prevented normal processing of income tax refunds. Adjusting for these unusual events, underlying revenue growth in August was 7.9 percent.

Individual Income Tax Withholding (57% of general fund revenues): The additional deposit day and having five Wednesdays in August buoyed withholding collections. Employers who have Friday payroll dates normally settle EFT payments for withholding on Wednesday. In addition, Wednesday is the due date for all employers to submit withholding payments to the Federal government and to states like Virginia that follow the federal schedule.

Collections of payroll withholding taxes grew 12.8 percent in August. Adjusting for the additional deposit day and extra Wednesday, withholding collections increased 6.1 percent. Year-to-date withholding growth is 9.7 percent -- ahead of the 5.6 percent annual estimate.

Individual Income Tax Nonwithholding (14% of general fund revenues): Because the first estimated payment for fiscal year 2006 is not due until September, collections in this source are not yet significant.

Nonwithholding collections in August totaled \$43.7 million -- 25.7 percent above the same month last year. Of the \$43.7 million, about 70 percent came from taxpayers filing extension returns and making final payments for tax year 2004. Year-to-date collections of nonwithholding are up 13.6 percent.

Individual Income Tax Refunds: The transition to its new computer system requires TAX to process a limited number of tax returns at a time, in order to diagnose system defects and correct them. This controlled production phase resulted in only \$447,000 in refunds being paid this August, compared to \$38.1 million in August of last year. Most refunds issued in August were to taxpayers who requested filing extensions and are now filing returns for tax year 2004.

Sales Tax (22% of general fund revenues): Collections of sales and use taxes, representing July sales, grew 16.6 percent in August. Year-to-date growth stands at 12.5 percent. Adjusting for the rate increase effective September 1, 2004, and the food tax reduction effective July 1, 2005, collections were up 8.6 percent for the month and 3.7 percent for the fiscal year to date.

Corporate Income Tax (4% of general fund revenues): The first estimated payment for fiscal year 2006 is due in September, so corporate income tax collections are not yet significant. Most of the \$18.6 million in corporate payments in August came from companies whose fiscal year runs on an unusual schedule. Year-to-date collections of corporate income tax total \$56.6 million -- mainly due to strong estimated payments paid last month by retailers.

Other Revenue Sources

The following list provides data on August collections for other revenue sources:

	Year-to-Date	Required to Meet Estimate
Insurance Premiums Taxes (3% GF revenues)	-0.5%	10.7%
ABC Taxes (1.1% GF revenues)	8.3%	-0.5%
Public Service Corporations (0.7% GF revenues)	0.4%	0.3%
Interest Income (0.7% GF revenues)	60.2%	-0.2%

All Other Revenue: All Other Revenue grew 49.5 percent in August -- \$111.9 million compared with \$74.9 million in August of last year. Substantial growth in the largest component -- wills, suits, deeds, and contract fees -- accounted for most of the growth. Of the \$75.5 million collected in wills, suits, deeds, and contract fees, \$67.9 million was recordation tax receipts. For the fiscal year, collections of All Other Revenue have grown 34.4 percent.

Lottery Revenues: Lottery profits increased 1.2 percent in August, with year-to-date growth of 3.3 percent. Although gross sales have increased 12.7 percent for the year, net revenue is slightly behind the annual growth rate of 4.3 percent.

Higher prize payouts in Pick 3 and Lotto South were mainly responsible. During the fall forecasting process, the Lottery Department will update its forecast to include estimates of the impact of North Carolina's recent decision to begin its own lottery.

Summary

Total general fund revenue collections grew 23.9 percent in August, and year-to date growth stands at 17.0 percent. Most of August's revenue growth was due to strength in payroll withholding, sales tax receipts, and recordation taxes. The growth rate was boosted by an additional deposit day (and additional Wednesday), comparison to a month last year which did not include tax policy changes affecting sales and recordation taxes, and TAX's inability to issue income tax refunds during the transition to its new computer system. Adjusting for these factors, underlying economics-based revenue growth in August was 7.9 percent, and economics-based revenue growth year-to-date stands at 6.7 percent.

September collections will include the first estimated payment for individual non-withholding and corporate income, as well as a quarterly payment for insurance premiums. September also completes the first quarter of the fiscal year. A better assessment of revenue performance will therefore be available then.