



BUDGET BRIEFING

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Third Quarter Revenue Report: Encouraging

Revenues

General Fund revenues for the first three quarters of 2006/07 total over \$19.3 billion, which is nearly \$250.5 million over the official estimate. We expect the revenue surplus to continue to increase through the remainder of the fiscal year. **While the story about the revenue surplus is heartening, remember that the surplus does not offset the structural deficit. Policymakers will still need to make difficult decisions for the budget year.**

Compared to collections for the same period last year, total General Fund collections are greater by \$934 million (or a healthy 5.1%).

Revenue collections for the month of March account for \$138 million of the year-to-date overage. Historically, March is an important tax collection month, with a large percentage of corporate taxpayers making their first quarterly estimated payments for the Corporate Net Income Tax and the

Capital Stock/Franchise Tax (CS/FT) and with electric, transportation and telecommunications companies remitting the Gross Receipts Tax. The tax revenue picture through March is detailed in Table 1.

Discussion of the Economy

The primary message from the Federal Reserve is that the economy's expansion is intact, but growth remains below potential.

The Moody's Economy.com probability of a national recession rose sharply in March to 28 percent, from February's 21 percent. The clearest sign of rising recession risks can be seen in the sharp moderation in consumer confidence and March's equity market correction. Unemployment insurance claims have also picked up some in March. However, the improvement in equity markets thus far in April is an encouraging sign.

According to March data, the Middle Atlantic region's

Preliminary General Fund Revenue Report Year-Through-March				
(\$s in millions)	Official Estimate	Actual Collections	\$ Change from Estimate	Annual Growth
GENERAL FUND TOTAL	\$19,077	\$19,328	\$250	1.3%
I. TAX REVENUE	\$18,743	\$19,007	\$264	1.4%
A. CORPORATION TAXES	\$3,895	\$4,158	\$263	6.8%
B. CONSUMPTION TAXES	\$7,153	\$7,114	-\$40	-0.6%
1. Sales	\$6,403	\$6,363	-\$40	-0.6%
a. Non-Motor Vehicle	\$5,547	\$5,533	-\$14	-0.3%
b. Motor Vehicle	\$856	\$830	-\$25	-3.0%
2. Cigarette	\$571	\$564	-\$6	-1.1%
3. Malt Beverage	\$18	\$19	\$1	3.2%
4. Liquor	\$162	\$168	\$6	3.5%
C. OTHER TAXES-TOTAL	\$7,695	\$7,734	\$40	0.5%
1. Personal Income	\$6,664	\$6,754	\$89	1.3%
a. Withholding	\$5,584	\$5,624	\$41	0.7%
b. Non-Withholding	\$1,081	\$1,129	\$49	4.5%
2. Realty Transfer	\$458	\$432	-\$26	-5.6%
3. Inheritance	\$578	\$558	-\$20	-3.5%
4. Minor & Repealed	-\$5	-\$9	-\$4	-84.1%
II. NON-TAX REVENUE	\$334	\$322	-\$12	-3.7%

Corporate and Non-tax number will differ some from Dept of Revenue final numbers due to preliminary nature of data.

Table 1: General Fund Revenue Report

(including Pennsylvania) probability of recession rose to 30.7% up from 25.8% in February. This new probability makes the Middle Atlantic the third most likely region to be in a recession in six months, behind the East North Central and West North Central regions. **The correction in the housing market is finally seeping through to the rest of the economy, hitting equity markets through the potential subprime mortgage crisis.**

Homebuilding is still a major struggle, subtracting 1.2 percentage points from overall growth in the fourth quarter of 2006. With the slowing in the economy since the middle of 2006, businesses are working to reduce stockpiles; inventories reduced growth by 1.2 percentage points in the fourth quarter of 2006. However, there are some positive growth areas. These positives are consumption, which continues to hold up, trade and government. Businesses are working through their inventory problems.

The consumer price index release from the Bureau of Labor Statistics brought encouraging news on inflation. Both the topline (all consumer goods) and core (everything except food and fuel) numbers for March came in below expectations. Topline inflation did accelerate during March, which was expected given higher energy prices. However, the increase was not as large as expected.

The core number was even better. Prices excluding food and energy rose just 0.1% for the month, and 0.061 % before rounding. This was the weakest monthly reading on core inflation in almost two years. Year-over-year core inflation dropped to 2.5%, after running at 2.7% in both January and February. March was the first time core inflation has been below 2.6% on a year-ago basis since May 2006. While it is certainly too soon to say that the threat from accelerating inflation has passed, the numbers indicate that inflation is not moving out of control.

Moody's reports that corporate profits fell in the fourth quarter of 2006, but remain near a record high, both in nominal dollars and as a share of GDP. Profit growth should resume as the expansion continues, although at a much slower pace than that seen over the past few years. High profits will support investment and hiring, keeping the expansion going. The primary risk to near-term growth is a downside one: problems in the mortgage market that spread to the broader financial system.

The two major sources for weakness in employment during the first half of the current fiscal year are housing-related jobs and auto manufacturing.

The chance of the economy being in a recession in six months is elevated and rising.

Corporation Taxes

The \$263 million year-to-date surplus in corporation taxes is driving the General Fund surplus. Total corporation tax receipts through March are \$310 million ahead of collections for the same period last year, representing a strong 8.1% annual growth.

March corporation tax receipts were nearly \$181 million (or 8.2%) over the monthly estimate. Strong March collections for both the Corporate Net Income (CNI) tax and the Capital Stock and Franchise Tax (CS/FT) provide a positive outlook for the second quarter 2007 estimated payments due in June.

For the month of March, CNI receipts came in approximately \$50 million above the monthly estimate, increasing the year-to-date surplus to nearly \$67.5 million. CS/FT receipts came in approximately \$31 million above the monthly estimate, increasing the year-to-date surplus to nearly \$68 million. Other selective business tax collections came in nearly \$97 million over estimate (or 5.7%). This surplus was largely due to the overage in the Gross Receipts tax.

Compared to collections for the same period last year, total CNI collections are greater by \$207.4 million (or 14.9%). CS/FT receipts are nearly \$58 million (or eight percent) lower than year-ago receipts, reflecting the continued phase out of the tax. Selective business receipts are \$162.3 million (or a strong 9.4%) above year-ago receipts.

The third major corporation tax - the Gross Receipts Tax (GRT) on electric, water, telecommunications and transportation companies – accounts for approximately 23 percent of corporate tax collections and was due in its entirety March 15. Gross Receipts tax collections came in nearly \$83 million (or seven percent) above the March estimate. The majority comes from strong electric and telecommunication performances. We do not anticipate any significant change in the GRT surplus during the remaining months of the fiscal year because no further GRT payments are due this year.

Given the positive outlook for CNI and CS/FT collections, **we will end the 2006/07 fiscal year with a significant surplus in total Corporate Tax collections.**

Sales and Use Tax

Total Sales and Use Tax receipts are approximately \$40 million below the official estimate through March. The shortfall reflects the continued performance lag in motor vehicle and non-motor vehicle sales, both of which did not meet their monthly estimates in March. **For the first three quarters of the fiscal year, non-motor vehicle sales tax receipts are \$14.2 million**

underestimate while motor vehicle sales tax receipts are \$25.3 million underestimate.

Compared to collections for the same nine-month period last year, total Sales and Use Tax collections are greater by nearly \$177 million. Non-motor vehicle sales are \$202 million (or a steady 3.8%) above year-ago receipts; however, motor vehicle sales are down nearly \$25.3 million (or three percent) compared to last year.

March Sales Tax receipts were nearly \$12.2 million below the monthly estimate, due to a nearly \$9 million shortfall in non-motor vehicle sales. March motor vehicle sales tax receipts fell short of the monthly estimate by \$3.2 million. We will monitor closely the collections in the remaining months of the fiscal year.

Personal Income Tax

Total Personal Income Tax (PIT) receipts are \$89 million overestimate through March, with both the withholding and non-withholding components of the PIT running ahead of estimate. Employer withholding payments on wages and salaries are above the official estimate, with year-to-date deposits nearly \$41 million (or 0.7%) above projections. One of the main drivers of the General Fund surplus is non-withholding payments on investment earnings and

proprietors' income, which are solidly above projections; with deposits \$48.7 million (or 4.5%) overestimate for the year. While we expect the PIT surplus to increase in the fourth quarter, we will have a fairly good indicator of how much the final PIT surplus will be after taxpayers make their final 2006 payments. These payments are typically tallied by the close of April; however, this year the tax filing date was extended for some, due to the April 16th storm, so payments are expected to spill over into the first few days of May. Consequently, we will closely monitor PIT deposits through the first week of May.

Non-Tax Revenue

Total non-tax revenues are approximately \$13 million below the year-to-date estimate, reflecting only a partial repayment of the Gaming Fund loan and a lag in the transfer of liquor store profits. This money will arrive in April, and **we can be confident of a strong performance in non-tax revenue.** Preliminary data show March non-tax revenues fell short of the monthly estimate by \$55 million (or a sizable 45 percent). This shortage is the result of delaying the first \$50 million transfer of Liquor Store profits and the \$25 million Gaming Fund repayment until April. We are optimistic that non-tax revenues will end the year overestimate.



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