State of Maryland
Board of Revenue Estimates

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March 9, 2007

Honorable Martin O'Malley
Governor, State of Maryland
State House
Annapolis, MD 21401

Dear Governor O'Malley:

In accordance with our continuing policy of keeping you fully advised of developments concerning Maryland's revenue prospects, the Board of Revenue Estimates has reviewed the current estimates of general fund revenue in light the most recent economic data and developments and recent revenue collections. Based on our review, the Board submits to you revised current law general fund estimates of $12.869 billion for fiscal year 2007 and $13.427 billion for fiscal year 2008. This represents a decline in the fiscal year 2007 estimate of $24.4 million and a decline in the fiscal year 2008 estimate of $25.8 million, for a combined reduction of $50.2 million.

The State's economy continues to expand. Employment growth for calendar year 2006 was 1.25%. Two service industries—education and health services and professional and business services—were among the fastest growing industries in the State last year; that trend is expected to continue. The unemployment rate declined to 3.9%, the lowest since 2000 and 0.75 percentage points below the national unemployment rate for 2006. Personal income growth moderated through the first three quarters of the calendar year (the latest available data), but it is above the ten-year average growth.

Our major concern for some time has been the State's housing market. Price growth has stagnated, active inventories are at six-year highs, and sales have fallen off. About 100,000 existing homes were sold in 2005, but only 79,000 in 2006. That falloff, along with a sharp drop in home equity loans and cash-out refinancing in the middle of the year, indicates that the direct and indirect support that real estate has given the State's economy over the past several years is ebbing. There have been some signs that the bottom may have been reached, but there is a possibility that the slowdown will continue for some time to come.

Despite the problems in the housing market, our economic forecast remains fundamentally unchanged from December—we are expecting continued though modest growth. The following table shows our economic forecast from December compared to the February forecasts of four recognized experts. Coupled with our analysis of recent economic developments, we discern no compelling reason to adjust the economic forecast.

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Comparison of Economic Forecasts for Maryland

	Employment		Personal Income		Wage & Salary Income	
	2007	2008	2007	2008	2007	2008
Board of Revenue Estimates	1.3%	1.5%	5.8%	5.7%	5.8%	5.8%
Moody's Economy.com	1.4%	1.3%	5.8%	5.2%	5.6%	5.3%
University of MD	1.5%	1.3%	5.3%	5.5%	5.8%	5.5%
RESI	1.4%	2.4%	5.3%	5.5%	5.3%	5.8%
Sage Policy Analysis	1.5%	1.5%	5.6%	6.0%	5.4%	5.9%

While the economic outlook is unchanged, our analysis of collection trends since December has led us to make these downward revisions. Individual income tax withholding has grown 4.6% through February, while expectations based on the December estimates called for 5.1% growth at this point, on the way to 5.3% growth for the full year. While withholding has been more volatile than expected over the past few months, due in part to some calendar issues, we believe it is prudent to reduce our forecast for withholding growth marginally to 5.1% for the fiscal year. The $31.8 million reduction in withholding brings the general fund individual income tax forecast down $19.4 million. The reduction to fiscal year 2007 withholding is expected to flow through to fiscal year 2008, reducing general fund revenue by $20.6 million.

Our analysis of the other components of the individual income tax reaffirms the December forecasts for those components. We are cognizant of the risk that capital gains will not be as large as we expect due to the slowing real estate market, and that could have an impact on April final payments. Refunds paid out through February, however, indicate that there is a possibility that full-year refunds may be lower than expected, providing some upside potential.

Collections of business franchise taxes have fallen short of expectations since our December meeting. We are lowering the estimate by approximately $5 million in both fiscal years 2007 and 2008 as a result. We expect the shortfall to date will be somewhat mitigated by a colder January and February than last year (and slightly colder than average), resulting in greater consumption of electricity and natural gas.

We have thoroughly examined the performance of the other revenue sources. The sales tax is tracking on line with our expectations. While lottery revenues have fallen short of the estimates through February, the deficit will be largely offset by the large Mega Millions jackpots of the last week and by another raffle game that the agency will run in April/May, which was unexpected at the time of the December forecast.

Several revenue sources are running ahead of our expectations. But these revenues—the corporate income tax, death taxes, and revenues from the clerks of court—are among the most volatile sources of revenue, and we believe under current circumstances it would not be responsible to increase these estimates. A number of other revenues, including the cigarette excise tax, are lagging slightly, but not enough to necessitate a downward revision.

We note that while these adjustments do not appreciably worsen the fiscal situation of the State, they do reaffirm that general fund revenue growth will be relatively weak at 3.9% and 4.3% for this year and next—substantially lower than the 9.9% average annual growth of the last three fiscal years. At this juncture, it appears likely that growth from existing revenue sources will not support expenditure growth over the coming years, and that solutions for the structural deficit will have to be found elsewhere. Should any of several major risks to the forecast occur—estimates of the risks of recession by the end of this year range from 15% to more than one in three—the State's structural deficit will become an even larger problem.

We will keep you informed of any major developments.

Sincerely,

Peter Franchot

Peter Franchot

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