COMMONWEALTH of VIRGINIA

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MEMORANDUM

TO: The Honorable Glenn Youngkin

THROUGH: The Honorable Jeff Goettman

FROM: Stephen E. Cummings

SUBJECT: January Revenue Report

Adjusting for policy actions and timing issues to better reflect underlying economic trends, general fund revenues were 4.5 percent higher in the first seven months of Fiscal Year 2023, compared to the same period of the previous year. For January, adjusted general fund revenues increased by 3.0 percent compared to January 2022. On an unadjusted basis, general fund revenues increased by 2.1 percent year-to-date.

Relative to the updated December forecast which reflected actual results through October, unadjusted general fund revenues are ahead of forecast by $78.7 million year-to-date. The updated forecast reflects proposed policy changes, including the Governor's tax relief package. Based on the advice of the Governor's Advisory Council on Revenue Estimates, the forecast also assumes a three-quarter recession beginning in the third quarter of Fiscal Year 2023.

January is a significant month for revenue collections. Regular monthly collections are due in withholding, sales and use taxes, and most minor sources. January collections also include the final of four individual estimated payments (installments) due for Tax Year 2022, and collections for the newly enacted Pass-Through Entity Tax (PTET). January PTET collections reflect payments that were received and processed in January but are applicable to Tax Year 2022. January saw some unexpected weakness in sales tax revenue. Withholding was also lower, but the lower withholding was distorted by filers whose January payments were delayed. The full extent of the impact of late withholding payments will only be known when the payments are received next month but our estimate is that this lowered withholding by $70-$100 million. A significant bounceback is expected to occur next month. Slow growth in withholding and sales tax collections were offset by stronger than expected collections in non-withholding and higher interest income.

Major policy and timing adjustments contributing to revenue growth include the impacts of the repeal of the Accelerated Sales Tax (AST) and the newly enacted Pass-Through Entity Tax, which combined added $798.9 million to fiscal year-to-date collections. These were offset by tax rebates and changes to the standard deduction which combined subtracted $1.4 billion to revenue growth, for a net subtraction of $583.3 million in the first seven months of Fiscal Year 2023.

Economic Review

Most recent economic data point in the direction of slowing growth in both the nation's and Virginia's economy. This slowdown is consistent with the updated December economic projections. Recent US employment data however continues to defy expectations of a slowdown.

- US GDP rose by 2.9 percent in the 4th quarter. Much of the strength was driven by inventory accumulation, a headwind to growth in the upcoming quarter.

- Consumer retail spending in December fell for the second consecutive month in what proved to be an overall disappointing holiday shopping season. Total sales for the October 2022 through December 2022 period were up 6.7 percent from the same period a year ago, barely keeping up with inflation.

- In another sign that consumers feel increasingly uneasy about the economy the Conference Board's Consumer Confidence Index decreased in January. The decrease was driven by a worsening in consumers' near-term outlook for income, business and job market conditions.

- On the business side, manufacturing activity in the U.S. contracted for the third consecutive month in January, according to the ISM manufacturing index. At 47.4, the first index reading of 2023 is a point lower than December's 48.4 index value and below the index's neutral threshold of 50.

- US Labor markets defied expectations of a slowdown. The January report showed a head scratching gain of 517,000 jobs and the average gain for the past three months of 356,000 is sharply higher than the initial estimate for the last three months of 2022—which came in below 250,000. Healthcare and leisure/hospitality remain the stalwarts of job growth, combining to add more than 200,000 jobs to the start of the year.

- Inflationary pressures are starting to subside but overall growth in the CPI, 6.4 percent year-over-year, remains significantly higher than the Fed's two percent target rate of inflation.

- The Federal Reserve raised the federal funds target rate by 25 basis points to 4.75 percent (upper range) at the February FOMC meeting. The Fed hinted for the first time that inflationary pressures are easing, but reiterated its commitment to bring down inflation to its target rate. Further rate increases are expected in the coming year with most economists expecting a terminal rate of 5-5.5 percent in 2023.

- December's preliminary employment data for Virginia shows overall annual average employment growth of 2.6 percent in 2022. In terms of the geographic distribution, the fastest growth occurred in the smaller metropolitan areas of Blacksburg-Christiansburg, Radford, and Staunton-Waynesboro where growth exceeded the statewide average.

- The seasonally adjusted unemployment rate increased by 0.2 percentage point to 3.0 percent in November.

- The Virginia establishment and household employment data will be revised in March.

January Revenue Collections

Through the first seven months of the fiscal year, adjusting for policy actions and timing issues, general fund revenues were up 4.5 percent. On an unadjusted basis, general fund revenues were 2.1 percent higher versus the projected 8.8 percent decline assumed in the Governor's proposed budget for the full fiscal year.

Collections for the month of January included $280.0 million in the newly enacted PTET, which caused overall monthly revenues to surge by 8.1 percent compared to the prior year. Adjusting for the PTET and smaller adjustments for withholding, general fund revenues were up 3.0 percent in January.

To date, PTET collections have totaled $670.8 million. However, this is merely a shift in the timing of receipts as PTET payments are offset by an equivalent credit against Virginia individual income tax when tax returns are filed, resulting in a net impact of zero later in the year.

Net Individual Income Tax (67% of general fund revenues): After adjusting for policy and timing issues, January net individual income tax payments were essentially flat, rising by 0.2 percent for the month and 7.5 percent on a fiscal year-to-date basis. Unadjusted revenues rose by 6.8 percent on a monthly basis and were up 0.7 percent year-to-date. This was mainly due to the $1.06 billion in tax rebates issued this year (in line with estimates of $1.049 billion). Performance in each component of individual income tax is as follows:

> ***Individual Income Tax Withholding (61% of general fund revenues)***: Collections of payroll withholding taxes were 9.3 percent higher for the month after taking into account the impact of the increased standard deduction and late payments that will be received in February. Fiscal-year-to-date, collections are 8.1 percent higher than the same period last year after adjustments, and 4.4 percent on an unadjusted basis. Through January, collections are trailing projections by $21.2 million. The slowdown that has occurred in withholding growth since the beginning of the year is consistent with our economic and revenue forecast which anticipates declining growth in employment, from 3.2 percent in Fiscal Year 2022 to 2.4 percent in Fiscal Year 2023.

> ***Individual Income Tax Non-withholding (19% of general fund revenues)***: January collections, after accounting for the newly enacted PTET were, respectively, 14.0 percent lower for the month and up 3.6 percent fiscal year-to-date. January's data provided the first indication that non-withholding liability is likely to be significantly lower in Fiscal Year

2023 and lower monthly collections are expected over the remainder of the fiscal year. Unadjusted fiscal year-to-date non-withholding collections increased by 24.4 percent in January compared to the previous year. This was due to the $280.0 million realized in PTET revenue that was collected this month. Fiscal year-to-date through January non-withholding collections are $107.1 million higher than projected.

Individual Income Tax Refunds (-13% of general fund revenues): Through January, the Department of Taxation has issued $1.4 billion in refunds compared with $380.5 million over the same period last year. Most of the increase is attributable to the $1.06 billion in taxpayer rebates. Adjusting for these rebates, income tax refunds fell 0.6 percent fiscal-year-to-date, $23.8 million higher than projected.

Sales Tax (19% of general fund revenues): Collections of sales and use taxes, reflecting December sales, fell 2.4 percent in January, but are up 4.9 percent year-to-date, after adjusting for the AST. Unadjusted sales tax collections are 10.3 percent higher year-to-date, trailing projections by $37.4 million. Sales tax revenue during the October -December holiday period came in lower than expected, increasing by only 2.8 percent, well below both the pace of inflation and the nation's rate of increase in spending. The shift in consumption from taxable goods to non-taxable services is likely dampening sales tax revenue growth more than anticipated.

Corporate Income Tax (7% of general fund revenues): Corporate income tax collections increased by 61.3 percent for the month of January. On a year-to-date basis, collections of corporate income taxes are 11.3 percent lower compared to the previous year, and below projections by $16.8 million. To-date, there are no policy actions impacting revenue collections. Corporate profit growth has slowed due to the slowing economy and margin compression from higher wages and costs which corporation are no longer able to pass along.

Wills, Suits, Deeds, Contracts (2% of general fund revenues): Collections of wills, suits, deeds, and contracts – mainly recordation tax collections – were 55.4 percent lower in January compared to the previous year. On a fiscal-year-to-date basis, collections are down 35.0 percent as higher interest rates have sharply curtailed sales of new homes and mortgage refinancing.

Insurance Premiums (2% of general fund revenues): Monthly collections of insurance company premiums were up 90.3 percent compared to the previous year.

Other Revenue Sources

The following list provides growth data on collections through January for other revenue sources:

	Year-to-Date	Annual Estimate
Interest Income (0.8% GF revenues)	*207.7%*	*190.4%*
ABC Taxes (1% GF revenues)	*0.0%*	*3.6%*

Interest income has almost tripled in the first half of the year compared to the previous year, totaling $198.7 million in the first seven months of the year and compared to a full year forecast of $222.6 million.

All Other Revenue (2% of general fund revenues): Receipts in All Other Revenue rose 20.5 percent in January to $307.7 million fiscal year-to-date compared with $249.2 million a year ago. On a year-to-date basis, collections of All Other Revenue rose 23.5 percent from the same period last year, above the annual estimate of a 3.4 percent increase.

Summary

Year-to-date collections are running ahead of the January updated projections by $78.7 million overall. Among major sources, growth in withholding collections are slowing, but the slowdown is largely anticipated in the forecast. Decelerating growth in sales tax collections are more concerning if the holiday sales period proves to be indicative of a sustained slowdown in spending or a rapid shift from consumption of taxable goods to services. Non-withholding revenue also continues to exceed projections, although there is still considerable uncertainty on upcoming payments due in May. Corporate income and deed recordation tax collections are trailing projections, but unanticipated weakness in these two sources is being offset by higher interest income. Upcoming February collections will provide initial insight into individual refunds for the filing season.