COMMONWEALTH of VIRGINIA

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<u>MEMORANDUM</u>

TO: The Honorable Glenn Youngkin

THROUGH: The Honorable Jeff Goettman

FROM: Stephen E. Cummings

SUBJECT: December Revenue Report

This month's revenue report incorporates the revised general fund revenue forecast on which the introduced 2024-26 biennial budget (HB/SB 30) and the amendments to the Fiscal Year 2024 budget (HB/SB 29) are based. The forecast reflects the recommendations of both the Joint Advisory Board of Economists and Governor's Advisory Council on Revenue Estimates. With the revisions, general fund revenues are projected to decline 0.6 percent for Fiscal Year 2024, compared to the 5.5 percent decline assumed in the amended budget enacted last September (Chapter 1, 2023 Special Session I). The forecast includes the impacts of various tax policy actions adopted in 2022 and 2023 and reflects the potential for a U.S. recession anticipated to begin in the fourth quarter of the current fiscal year and lasting three quarters.

For the month of December, total general fund revenues grew by 0.2 percent versus the same period last year. Year-to-date, general fund revenues are up 7.1 percent through the first six months of Fiscal Year 2024. Adjusting for the effects of Pass-Through Entity Tax (PTET) collections and refunds, and the associated timing of enacted policy actions to better reflect underlying economic trends, revenue collections increased by 4.8 percent in December and are up 5.9 percent year-to-date.

In comparison to the revenue forecast assumed in the Governor's amendments to the Fiscal Year 2024 budget and accounting for monthly variations in tax collections, year-to-date total general fund revenues are ahead of projections by $363.2 million (2.8 percent). For the month, revenues were ahead of forecast by $174.7 million (6.4 percent). Revenues in excess of the forecast are primarily attributable to individual income tax withholding and non-withholding collections.

Excluding non-withholding and refunds, which continue to be distorted by PTET, year-to-date collections are ahead of plan by $85.8 million, a variance of 0.7 percent.

December is a significant month for revenue collections. Regular monthly collections are due in withholding, sales and use taxes, and most minor sources. December collections also include estimated payments for corporate filers as well as payments for the elective Pass-Through Entity Tax.

Among major sources, withholding was $79.6 million higher than projected in December and corporate tax collections were $60.3 million lower. Sales tax revenues, reflecting November sales, were up by $9.1 million. The bulk of sales tax collections from the holiday shopping season will be received in January. Overall collections from other sources of revenues generally exceeded the Forecast as discussed in more detail in the following sections.

Economic Review

- U.S. nonfarm payrolls increased 216,000 in December and the unemployment rate was unchanged at 3.7 percent. Payroll gains for October and November were revised down by a total of 71,000, bringing the net gain, including revisions, to 145,000. Over the past three months, private payrolls have increased, on average, by 115,000 per month.

- U.S. Real GDP growth for the third quarter was revised down in December from 5.2 percent to 4.9 percent according to the "third" estimate released by the Bureau of Economic Analysis.

- In December, the Consumer Price Index (CPI) ticked up to 3.4 percent year-over-year, higher than the 3.1 percent annual change reported in November, but more than three percentage points below the 6.5 percent reading in December 2022. The twelve-month change in “core” CPI, which excludes food and energy, slowed slightly to 3.9 percent, down from 4.0 percent in October and November.

- At its December meeting, the Federal Reserve maintained the target for the federal funds rate at a range of 5.25 percent to 5.50 percent. The Fed is expected to keep rates unchanged following its January 30-31 meeting. While the timing of future rate changes is uncertain, financial markets anticipate that the Fed will begin to cut rates before the end of calendar year 2024.

- On January 7, leaders in Congress announced a tentative budget agreement. The agreement is a major step toward passing a deal to keep the federal government open ahead of a January 19 deadline, when funding for several agencies, such as the U.S. Departments of Agriculture, Transportation and Housing and Urban Development, expires. Lawmakers still need to finalize spending bills for those agencies before the deadline. The rest of the federal government would lose funding after February 2 if no agreement is reached.

- In November, Virginia’s nonagricultural employment, from the monthly establishment survey increased by 6,200 and was 1.6 percent higher than in November 2022. The labor force participation rate increased by 0.1 percentage points to 66.9 percent.

- Virginia's unemployment rate in November increased by 0.2 percentage points to 2.9 percent, seasonally adjusted, which is 0.3 percentage points below the rate from a year ago.

- The economy continues to face downside risks, including the continuing impact of high interest rates, the potential for an escalation of the armed conflict in Gaza, the real estate crisis in China, and the spend down of consumers' pandemic savings, which will likely dampen economic growth. However, the consensus outlook among professional economists has improved in recent months. According to the National Association for Business Economics' December survey, three out of four economists put the risk of recession in the next twelve months at 50 percent or less.

December Revenue Collections

General fund revenues increased 0.2 percent year-over-year for the month of December on an unadjusted basis. Fiscal year-to-date through December 31, general fund revenues are up 7.1 percent over the prior year.

Adjusting for policy and the timing of refunds related to the Pass-Through Entity Tax (PTET), December revenues increased by 4.8 percent and are up 5.9 percent year-to-date. Adjusting for policy, but excluding PTET adjustments, revenues are up 2.1 percent through December.

Net Individual Income Tax (67% of general fund revenues): Unadjusted revenues increased by 0.6 percent for the month compared to last year. Year-to-date net individual income tax collections are up 6.4 percent. Compared to the forecast assumed in the amended budget, year-to-date net individual income tax collections are ahead of projections by $436.6 million, driven by higher-than-expected withholding and non-withholding receipts and lower than anticipated refunds.

Performance in each component of individual income tax is as follows:

Individual Income Tax Withholding (58% of general fund revenues): Collections of payroll withholding taxes were 3.8 percent higher for the month on an unadjusted basis. Fiscal-year-to-date, collections are 5.1 percent higher than the same period last year after adjustments, and up 2.1 percent on an unadjusted basis. Compared to the Forecast assumed in HB/SB 29, withholding revenues are ahead by $159.2 million year-to-date.

Individual Income Tax Non-withholding (21% of general fund revenues): December collections increased by 5.1 percent and are up 6.5 percent for the year, both on an unadjusted basis. Through December, non-withholding receipts are $355.1 million ahead of forecast.

Individual Income Tax Refunds (-12% of general fund revenues): Through December, the Department of Taxation has issued $1,125.1 million in refunds compared with $1,378.5 million over the same period last year, a decrease of 18.4 percent.

Sales Tax (16% of general fund revenues): Collections of sales and use taxes, reflecting November sales, declined 4.7 percent in December and are down 1.3 percent year-to-date. Fiscal-year-to-date, sales and use tax revenues are $15.1 million below projections. Adjusting for the elimination of the State sales tax on grocery and the end of Accelerated Sales Tax, sales tax collections are up 1.2 percent year-to-date.

Corporate Income Tax (8% of general fund revenues): Monthly collections fell by 2.5 percent year-over-year, and year-to-date growth is at 14.8 percent. Compared to forecast, corporate income tax collections are slightly ahead of plan at $12.8 million over projections year-to-date.

Wills, Suits, Deeds, Contracts (2% of general fund revenues): Collections of wills, suits, deeds, and contracts – mainly recordation tax collections – were 4.9 percent higher in December compared to the previous year. On a fiscal-year-to-date basis, collections are down 16.7 percent as higher interest rates have curtailed residential and commercial property sales and mortgage refinancing. Compared to the forecast, collections in this source are behind projections by $21.9 million.

Insurance Premiums (2% of general fund revenues): General fund receipts totaled $104.3 million. December marks the first month in Fiscal Year 2024 that collections of insurance company premiums license taxes are retained in the general fund after satisfying the requirement that $217.8 million be transferred to the Transportation Trust Fund per Chapter 986, 2007 Acts of the Assembly. Year-to-date collections are down 11.0 percent versus a forecasted decline of 1.0 percent.

Other Revenue Sources

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

	Year-to-Date	**Annual Estimate**
Interest Income (2% GF revenues)	184.9%	84.2%
ABC Taxes (1% GF revenues)	3.0%	5.4%

Interest income earnings totaled $494.8 million in the first six months of the year compared to $173.7 million for the same period of the prior fiscal year. Please note, however, that interest is earned monthly in the general fund and credited to nongeneral funds on a quarterly basis in October, January, April, and June. Based on the forecast and anticipated nongeneral fund allocations, interest income through December is generally on plan. January month-end results, which will include scheduled transfers to nongeneral fund accounts, will provide a better measure of interest income relative to forecast.

All Other Revenue (2% of general fund revenues): On a year-to-date basis, collections of All Other Revenue declined by 9.7 percent to $228.0 million fiscal year-to-date compared with $252.5 million a year ago.

Standard Deduction Increase

The twentieth enactment clause of the 2023 Special Session I Amendments to the 2023 Appropriation Act (Chapter 1, 2023 Special Session I) increases the standard deduction from $8,000 to $8,500 for single filers and from $16,000 to $17,000 for married filers filing jointly for taxable years beginning on or after January 1, 2024, but before January 1, 2026, contingent on the Auditor of Public Accounts certifying individual withholding growth of at least the growth rate in the official revenue estimate contained in Chapter 1 for the six month period of July 2023 through December 2023.

Actual withholding collections grew 2.1 percent for the July to December period, well ahead of the 0.7 percent decline assumed in Chapter 1. While the Auditor of Public Accounts must certify that results met the requirement in order to effectuate the increase in the standard deduction, the December revenue report indicates that the threshold was met.

Summary

Through the first six months of the fiscal year, year-to-date collections are up 7.1 percent compared to last year and are running ahead of projections assumed in the Governor's proposed Fiscal Year 2024 amended budget by $363.2 million. Net individual income tax collections are ahead of projections. Corporate income, sales tax, and interest income are generally in line with projections, and other minor sources, notably recordation tax and insurance premiums licenses tax collections, are running below projections.

Economic indicators continue to indicate a slowing economy. Interest rates remain elevated, employment growth is moderating, and inflation measures are softening. And while the consensus outlook of professional economists has improved in recent months, downside risks remain, including the continuing impact of high interest rates, uncertainty around escalating conflict in the middle east, the spend down of consumers' pandemic savings, and the potential for a federal government shutdown. We will continue to monitor geopolitical and macroeconomic events as they unfold and make the necessary mid-session revenue forecast adjustments as needed after the release of January's revenue report next month.