COMMONWEALTH of VIRGINIA

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MEMORANDUM

TO: The Honorable Glenn Youngkin

THROUGH: The Honorable Jeff Goettman

FROM: Stephen E. Cummings

SUBJECT: December Revenue Report

Adjusting for policy actions and timing issues to better reflect underlying economic trends, general fund revenues were 6.5 percent higher in the first six months of Fiscal Year 2023, compared to the same period of the previous year. For the month of December, adjusted general fund revenues were 0.7 percent higher compared to December 2021. On an unadjusted basis that is reflective of the budgeted revenues, general fund revenues increased by 0.8 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 $79.3 million year-to-date. The updated forecast reflects proposed policy changes, including the Governor's proposed 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. With year-to-date results ahead of plan, Finance remains confident that in coming months, revenues will continue to meet or exceed the forecast, resulting in a $3.6 billion year-end surplus.

December is a significant month for revenue collections. Regular monthly collections are due in withholding, sales and use taxes, and most minor sources. Stronger than expected collections occurred in the individual income taxes and other taxes, mainly due to higher interest income. These have more than offset unexpected weakness in corporate income and deed tax collections. December collections also include estimated payments for corporate filers as well as payments for the recently enacted optional Pass-Through Entity Tax (PTET), which affects the timing of payments but will not impact overall state tax liability.

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 $519 million to collections fiscal year-to-date. These were offset by tax rebates and changes to the standard deduction which subtracted $1.23 billion to revenue growth, for a net subtraction of $718 million in the first six months of Fiscal Year 2023.

Economic Review

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.

- US payrolls rose by only 223,000 jobs in December, the smallest gain in two years. Wage pressures also are subsiding. Weekly earnings were 3.4 percent higher compared to the previous year, down from readings of over 5 percent earlier in 2022.

- The Conference Board Leading Economic Index decreased by 1.0 percent in November and is now down 3.7 percent over the six-month period between May and November 2022.

- Among the indicators pointing to recession the yield curve (2YR-10YR) has now sharply inverted with short term yields 60 basis points higher than long term yields.

- Consumer retail spending in November, an early indicator for the important holiday shopping season declined by 0.6 percent suggesting that consumer balance sheets are starting to buckle under persistently higher prices.

- Inflationary pressures continued to subside in December. The overall CPI declined by 0.1 percent for the month meeting expectations. Year-over-year, however, inflation remains 6.5 percent higher compared to the previous year, significantly higher than the Fed's two percent target rate of inflation.

- At the FOMC December meeting, the Federal Reserve raised the federal funds target rate by another 50 basis points to 4.5 percent (upper range) and reiterated its commitment to bring down inflationary pressures. Further rate increases are expected in the coming year with the dot plot indicating a target range of 5-5.25 percent next year.

- In Virginia, payroll employment declined by 2,000 jobs in the month of November but were up 3,300 for the 3-month average, leaving overall employment essentially where it stood before the pandemic. In terms of the geographic distribution, the metropolitan areas of Blacksburg-Christiansburg, Radford, Staunton-Waynesboro, and Winchester, are all above pre-pandemic levels while the remaining metro areas remain below the previous peak. The seasonally adjusted unemployment rate increased by 0.1 percentage point to 2.8 percent in November. Resident employment measured by the household survey was down by almost 7,400 jobs in November and down 3,000 on a 3-month average basis.

- Year-to-date through November however, average weekly earnings in Virginia are 4.5 percent higher than the previous year, continuing to drive strength in withholding collections.

December Revenue Collections

Through the first half of the fiscal year, adjusting for policy actions and timing issues, general fund revenues were up 6.5 percent. On an unadjusted basis, general fund revenues were 0.8 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 December alone were largely skewed by the newly enacted PTET, which caused 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 0.7 percent higher in December than in the previous year.

As structured, the PTET enables electing unincorporated business filers (primarily partnerships and S-corps) to fully deduct state and local taxes. Since this is the first year of implementation of the PTET in Virginia, and in order to meet the tax year deadline of December 31, 2022 to fully deduct state and local taxes, this month saw collections of PTET revenue totaling $391 million. This is merely a shift in the timing of receipts because the PTET payment is offset by an equivalent credit against Virginia individual income tax when filers file tax returns, 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, December net individual income tax payments rose by 3.2 percent for the month and 8.5 percent on a fiscal year-to-date basis. Unadjusted revenues rose by 15.2 percent on a monthly basis and were down 0.8 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 3.3 percent higher for the month after taking into account the impact of the increased standard deduction and number of paydays, one lower compared to December FY 2022. Fiscal-year-to-date, collections are 7.9 percent higher than the same period last year after adjustments, and 5.5 percent on an unadjusted basis. So far collections are exceeding projections by $17.5 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 FY 2022 to 2.5 percent in FY 2023.
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> ***Individual Income Tax Nonwithholding (19% of general fund revenues)***: December collections, after accounting for the newly enacted PTET were, respectively, 12.0 percent and 13.1 percent higher for the month and fiscal year-to-date. Unadjusted fiscal year-to-date non-withholding collections were three times higher in December FY 2023 compared to the previous year. This was due to the $391 million realized in PTET revenue that was collected for the first time this year. Fiscal year-to-date through December non-withholding collections are $75.2 million higher than projected.

Individual Income Tax Refunds (-13% of general fund revenues): Through December, the Department of Taxation has issued $1.4 billion in refunds compared with $342.4 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 increased 14.6 percent fiscal-year-to-date, $32.3 million higher than projected.

Sales Tax (19% of general fund revenues): Collections of sales and use taxes, reflecting November sales, rose 4.7 percent in December and by 6.4 percent year-to-date, after adjusting for the AST. Unadjusted sales tax collections are 13.2 percent higher year-to-date, trailing projections by $11 million. At this time, it is too early to assess whether the weakness seen in December is due to shifting of holiday shopping patterns, or reflective of higher than anticipated slowing in consumer spending. This should become more apparent as data on the holiday season becomes available next month.

Corporate Income Tax (7% of general fund revenues): Corporate income tax collections decreased by 16.9 percent for the month of December. On a year-to-date basis, collections of corporate income taxes are 15.7 percent lower compared to the previous year, and below projections by $9.2 million. So far to-date there are no policy actions impaction revenue collections so unadjusted and adjusted results are analogous. 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 47.3 percent lower in December compared to the previous year. On a fiscal-year-to-date basis, collections are down 31.9 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 2.0 percent lower compared to the previous year.

Other Revenue Sources

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

	Year-to-Date	Annual Estimate
Interest Income (0.8% GF revenues)	170.7%	190.4%
ABC Taxes (1% GF revenues)	-3.6%	3.6%

Interest income has almost tripled in the first half of the year compared to the previous year, totaling $174 million in the first six months of the year and compared to a full year forecast of $223 million.

All Other Revenue (2% of general fund revenues): Receipts in All Other Revenue rose 26.6 percent in December to $40.0 million compared with $31.6 million a year ago. On a year-to-date basis, collections of All Other Revenue rose 24.1 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 December updated projections by $79.3 million overall. Among major sources, withholding and sales tax growth are slowing as anticipated in the forecast. Withholding is running ahead of projections, while sales tax collections are trailing slightly. Non-withholding revenue also continues to exceed projections, although there is still considerable uncertainty on upcoming collections for the tax year filing season. 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 January collections will provide important information on fourth quarter estimated payments (non-withholding) and final results for the holiday shopping season.