COMMONWEALTH of VIRGINIA

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MEMORANDUM

TO: The Honorable Glenn Youngkin

THROUGH: The Honorable Jeff Goettman

FROM: Stephen E. Cummings

SUBJECT: February Revenue Report

Adjusting for policy actions and timing issues to better reflect underlying economic trends, general fund revenues were 4.1 percent higher in the first eight months of Fiscal Year 2023, compared to the same period of the previous year. For February, adjusted general fund revenues fell by 0.8 percent compared to February 2022. On an unadjusted basis, general fund revenues increased by 1.2 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 $111.3 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. While results have exceeded expectations based upon a stronger than expected economy since the time of our forecast, we continue to expect a similar downturn two to three quarters later in our forecast period.

February is one of the smallest revenue collection months and marks the beginning of the tax filing season when refunds for the tax year, just ended, begin to be issued. Regular monthly collections are due in withholding, sales and use taxes, and most minor sources. As expected, refunds in February almost doubled from $280.1 million last year to $526.7 million. The unusually large growth in refunds can be attributed to the increased standard deduction, the expansion of the earned income tax credit (EITC) as well as the subtraction for military retirement pay. February also saw a rebound in withholding as payments expected in January were remitted this month. Sales tax revenue was also higher compared to the previous year.

Other major policy and timing adjustments, besides the increased standard deduction and the enhanced EITC, contributing to revenue growth include the impacts of the repeal of the Accelerated Sales Tax (AST) and the newly enacted Pass-Through Entity Tax. Together, these factors have added $679.3 million to fiscal year-to-date collections.

Economic Review

The collapse of Silicon Valley Bank and Signature banks has exposed unexpected and problematic side effects from the rapid rise in short- term interest rates. While the uncertainty facing the banking system through this past weekend was concerning and we were tracking it closely, it appears that such systemic concerns have been addressed by actions taken by the Federal Reserve and FDIC.

- Fed monetary policy had appeared to be on a path of continued interest rate hikes to curb ongoing inflationary pressures. Now, expectations are that the Fed may remain in a holding pattern given the sensitivity of the banking sector. and the broader implications of any impact on consumer confidence.

- Offsetting this is the fact that recent economic news in February has been dominated by data showing unexpected strength in the economy. US employment defied expectations adding 311,000 jobs in February, following a gain of 504,000 jobs in January.

- Notable job gains occurred in leisure and hospitality, retail trade, government, and health care. The unemployment rate, however, edged up to 3.6 percent from 3.4 percent in January.

- Inflationary pressures, though declining, continue to be elevated. The CPI rose 0.4 percent in February, coming on the heels of a 0.5% increase in January. Relative to a year-ago, CPI was up 6.0 percent, while core CPI was up 5.5 percent. Prices increases related to services, such as housing, show few signs of easing.

- Revised establishment employment data for calendar years 2021 and 2022 was released by the Bureau of Labor Statistics and Virginia Employment Commission on March 13. The revisions added about 0.2 percent to the annual averages for 2021 and 2022, compared to 0.4 for the U.S, with growth in employment still trailing the U.S. since the pandemic.

February Revenue Collections

Through the eight months of the fiscal year, adjusting for policy actions and timing issues, general fund revenues were up 4.1 percent. On an unadjusted basis, general fund revenues were 1.2 percent higher versus the projected 8.8 percent decline assumed in the Governor's proposed budget for the full fiscal year.

Net Individual Income Tax (67% of general fund revenues): After adjusting for policy and timing issues, on a fiscal-year-to-date basis, net individual income tax payments rose 6.3 percent. Unadjusted revenues fell by 16.1 percent on a monthly basis and were down 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 5.1 percent higher for the month after taking into account the impact of the increased standard deduction and payments expected in January that were received in February. Fiscal-year-to-date, collections are 7.8 percent higher than the same period last year after adjustments, and 4.7 percent on an unadjusted basis. Through February, collections are trailing projections by $30.1 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.
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> ***Individual Income Tax Non-withholding (19% of general fund revenues)***: Non-withholding tax collections, after adjusting for the newly enacted PTET, are running 3.7 percent higher fiscal year-to-date. February is not a meaningful month for this source; however, January had the first monthly decline this fiscal year and is an early indication that non-withholding collections will be lower in fiscal year 2023 relative to fiscal year 2022. Fiscal year-to-date through February non-withholding collections are $120.6 million higher than projected.
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> ***Individual Income Tax Refunds (-13% of general fund revenues)***: Through February, the Department of Taxation has issued close to $2.0 billion in refunds compared with $660.6 million over the same period last year. Most of the increase is attributable to the $1.06 billion in taxpayer rebates along with the increased standard deduction and an expansion of the earned income tax credit (EITC). Adjusting for these tax policy changes, income tax refunds increased 18.8 percent fiscal-year-to-date, $21.9 million higher than projected. Included in year-to-date refund totals is $5.6 million in taxpayer rebates issued to taxpayers who filed returns after the scheduled deadline of November 1, 2022.

Sales Tax (19% of general fund revenues): Collections of sales and use taxes, reflecting January sales, grew 10.8 percent in February and are up 5.5 percent year-to-date, after adjusting for the termination of the AST program and the elimination of the State sales tax on grocery. Unadjusted sales tax collections are 9.7 percent higher year-to-date, trailing projections by $29.1 million. The continuing 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 fell 42.6 percent for the month of February. On a year-to-date basis, collections of corporate income taxes are 12.0 percent lower compared to the previous year, and below projections by $31.1 million. To-date, there are no policy actions impacting revenue collections. Corporate profit growth has slowed due to the slowing economy and margin compression as corporations are finding it harder to pass along higher costs to consumers.

Wills, Suits, Deeds, Contracts (2% of general fund revenues): Collections of wills, suits, deeds, and contracts – mainly recordation tax collections – were 32.0 percent lower in February compared to the previous year. On a fiscal-year-to-date basis, collections are down 34.7 percent as higher interest rates have sharply curtailed home sales and mortgage refinancing.

Insurance Premiums (2% of general fund revenues): Monthly collections of insurance company premiums were down 18.2 percent compared to the previous year. On a fiscal year-to-date basis, insurance company premiums are up 30.6 percent.

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)	250.3%	190.4%
ABC Taxes (1% GF revenues)	1.5%	3.6%

Interest income has more than tripled in the first eight months of the year compared to the previous year, totaling $252.8 million, compared to a full year forecast of $222.6 million.

All Other Revenue (2% of general fund revenues): On a year-to-date basis, collections of All Other Revenue rose 27.4 percent to $345.3 million fiscal year-to-date compared with $278.7 million a year ago.

Summary

Year-to-date collections are running ahead of the February projections by $111.3 million. Among major sources, growth in withholding collections is slowing, but the slowdown is largely anticipated in the forecast. Non-withholding revenue also continues to exceed projections, although there is still considerable uncertainty on upcoming payments due in May. The continuing shift in consumption from taxable goods to non-taxable services is likely dampening sales tax revenue growth more than anticipated. Corporate income and deed recordation tax collections are trailing projections, but unanticipated weakness in these two sources is being offset by higher interest income. March collections will provide additional insight into individual refunds for the filing season.