COMMONWEALTH of VIRGINIA

Stephen E. Cummings
Secretary of Finance

P.O. Box 1475
Richmond, Virginia 23218

April 14, 2023

<u>MEMORANDUM</u>

TO: The Honorable Glenn Youngkin

THROUGH: The Honorable Jeff Goettman

FROM: Stephen E. Cummings

SUBJECT: March Revenue Report

Relative to the updated December forecast ("the Forecast"), unadjusted general fund revenues are ahead of the Forecast by $124.2 million year-to-date. As has been the case for the last several months, March results exceeded the Forecast, adding to our confidence in the projection of $3.6 billion available to support the implementation of the Administration's proposed policy initiatives. The Forecast reflects these proposed policy changes, including your tax relief package.

Consistent with our expectations, March revenues, unadjusted for policy or timing impacts, fell by 3.8 percent compared to March 2022 mainly due to higher refund issuance. Individual income tax refund processing continued to ramp up in March. As expected, refunds in March increased from $389.8 million last year to $574.5 million. The large growth in refunds can be attributed to the increased standard deduction, the expansion of the earned income tax credit (EITC), and the subtraction for military retirement pay.

Results for the two largest individual sources of revenues, withholding and sales tax collections, were mixed. Withholding came in essentially as expected after taking into account timing issues. Sales tax collections were modestly lower than anticipated, 1.9 percent lower for the month than the previous year in spite of continued high inflation.

Other major policy and timing adjustments, besides the aforementioned increase in the 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 $629.2 million to fiscal year-to-date collections.

We continue to have confidence in our Forecast, which results in $3.6 billion in available resources for an amended budget. Adopting an amended budget can provide an additional $1 billion to the $4 billion in tax relief already provided by your Administration, $230 million to implement Right Help Right Now to address pressing mental health needs, $500 million for site development to position Virginia to Compete to Win, as well as investments in education, public safety, and resiliency.

Economic Review

Since publishing of the Forecast, the economy has performed a bit better than was anticipated. We anticipated that we would be entering a recession at this time, which would persist for six to nine months, we continue to anticipate a recession, which is accounted for in our Forecast, but believe it will begin three to six months later. An unanticipated development was the collapse of Silicon Valley and Signature Banks but, as a result of additional short term lending capacity provided by the Federal Reserve, the banking system seems to have stabilized.

In summary, key economic data for the month of March is as follows:

- CPI data for March showed overall inflation easing to 5.0 percent compared to the previous March reading of 8.5 percent. Rent price increases may have finally begun to ease, which accounts for one-third of the CPI, and is a lagging data point.

- The Fed is prioritizing its mandate to ensure price stability, confident that the banking system is sound and that the central bank has the capability to adequately quell any further financial system stress. The committee unanimously agreed to lift the target range for the Federal Funds rate by 25 basis points to 4.75 percent to 5 percent but softened its stance on subsequent hikes. The market currently expects one more 25 basis point hike in May and no further hikes thereafter.

- Job gains in March totaled 236,000, in line with expectations. The average monthly job gain for the first three months of 2023 is 345,000 – well below the monthly average of 561,000 in the first quarter of 2022.

- Average hourly earnings growth came in just below 0.3 percent over the month, and year-over-year growth dropped to 4.2 percent – its lowest since mid-2021.

- Virginia’s seasonally adjusted unemployment rate held steady in February at 3.2 percent, which is 0.3 of a percent above the rate from a year ago. Virginia’s nonfarm employment increased by 3,200 jobs in February.

March Revenue Collections

Through March on an unadjusted basis, general fund revenues were 0.6 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 4.6 percent on a fiscal year-to-date basis. As anticipated, year-over-year unadjusted monthly revenues fell by 9.7 percent and were down 1.8 percent year-to-date. The decline in annual net individual income tax collections can be mainly attributed to the $1.06 billion in tax rebates issued this year (in line with estimates of $1.048 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 7.1 percent higher for the month after taking into account the impact of the increased standard deduction. Fiscal-year-to-date, collections are 7.7 percent higher than the same period last year after adjustments, and 4.4 percent on an unadjusted basis. Through March, collections are trailing projections by $32.3 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)***: Non-withholding tax collections, after adjusting for the newly enacted PTET, are running 2.5 percent higher fiscal year-to-date. March is not a significant month for collections in this source but does mark the beginning of our tax due processing season which reaches its peak from mid-April to early May. Fiscal year-to-date through March, non-withholding collections are $148.1 million higher than projected.
>
> ***Individual Income Tax Refunds (-13% of general fund revenues)***: The main income tax filing season began in February. Through March, the Department of Taxation has issued over $2.5 billion in refunds compared with $1.1 billion 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, the expansion of the earned income tax credit (EITC) and the military retirement subtraction. Adjusting for these tax policy changes, income tax refunds increased 32.9 percent fiscal-year-to-date, $11.5 million higher than projected.

Sales Tax (19% of general fund revenues): Collections of sales and use taxes, reflecting February sales, grew 3.8 percent in March and are up 4.8 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 8.5 percent higher year-to-date, trailing projections by $60.1 million. Sales tax collections have been slowing over the last four months due to the continuing shift in consumption from taxable goods to non-taxable services, combined with higher interest rates slowing purchases of higher dollar items. The full implementation of the repeal of the AST in June of this year will also cause revenue growth to slow further.

Corporate Income Tax (7% of general fund revenues): Corporate income tax collections increased by 82.6 percent in March. On a year-to-date basis, collections of corporate income taxes are 6.3 percent lower compared to the previous year, and below projections by $32.4 million. To-date, there are no policy actions impacting revenue collections. The surge in corporate income tax payments in March can be attributed to several large corporations making final payments in March this year that they remitted in April last year.

Wills, Suits, Deeds, Contracts (2% of general fund revenues): Collections of wills, suits, deeds, and contracts – mainly recordation tax collections – were 33.7 percent lower in March compared to the previous year. On a fiscal-year-to-date basis, collections are down 34.6 percent as higher interest rates have sharply curtailed home sales and mortgage refinancing.

Insurance Premiums (2% of general fund revenues): Annual tax returns from insurance companies are due March 1. Monthly collections of insurance company premiums were down 59.2 percent compared to the previous year in March. However, combined with payments received at the end of February, on a fiscal year-to-date basis, insurance company premiums are up 15.4 percent.

Other Revenue Sources

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

	Year-to-Date	Annual Estimate
Interest Income (0.8% GF revenues)	*295.7%*	*190.4%*
ABC Taxes (1% GF revenues)	*1.5%*	*3.6%*

Interest income is almost four times higher through the first three quarters of the year compared to the previous year, totaling $313.3 million and 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 20.7 percent to $383.8 million fiscal year-to-date compared with $317.9 million a year ago.

Summary

Year-to-date collections are running ahead of the December forecast by $124.2 million. Among major sources, growth in withholding collections is slowing, but the slowdown was anticipated in the forecast. Non-withholding revenue collections have been solid over the first three quarters of the fiscal year. The fourth quarter accounts for more than 60 percent of the full year collections for this revenue source and we will be watching April results closely. We believe our Forecast is prudent, reflecting a 25.3 percent decline in non-withholding, higher than the two previous economic and stock market downturns over the past 25 years. The individual refund processing season has gotten off to a strong start with April being the peak of refunding activity.

Higher interest rates and the continuing shift in consumption from taxable goods to non-taxable services appears to be dampening sales tax revenue growth more than anticipated. Corporate income tax collections were robust in March although this could be due to an earlier remittance of taxes with year-end returns. Surging interest income is offsetting weaknesses in other minor sources, particularly deed recordation tax collections. April will be a bellwether month as the last three months of the fiscal year are significant collections months. In addition to estimated and final payments from both corporations and individuals due in April and May, estimated payments are again due in June.

Based upon collections to date, we continue to have confidence in our Forecast, which results in $3.6 billion in available resources. Those resources support our ongoing focus on enacting an amended budget to immediately implement critical spending initiatives for mental health, education, public safety, resiliency, and adding $1 billion to the $4 billion in tax relief already provided by your Administration.

ECONOMIC AND REVENUE REVIEW AND UPDATE

Stephen E. Cummings
Secretary of Finance
Steven Giachetti, Chief Economist
Commonwealth of Virginia
www.finance.virginia.gov
April 2023

TOPICS FOR DISCUSSION

ECONOMIC UPDATE

MARCH FISCAL YEAR-TO-DATE REVENUE COLLECTIONS

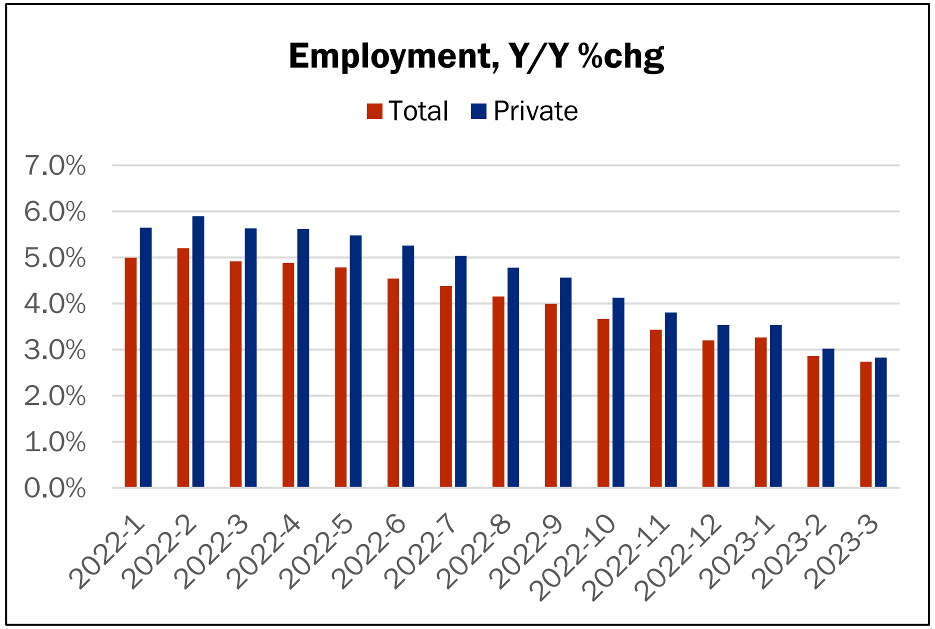
COLLECTION BY MAJOR SOURCES AND DRIVERS

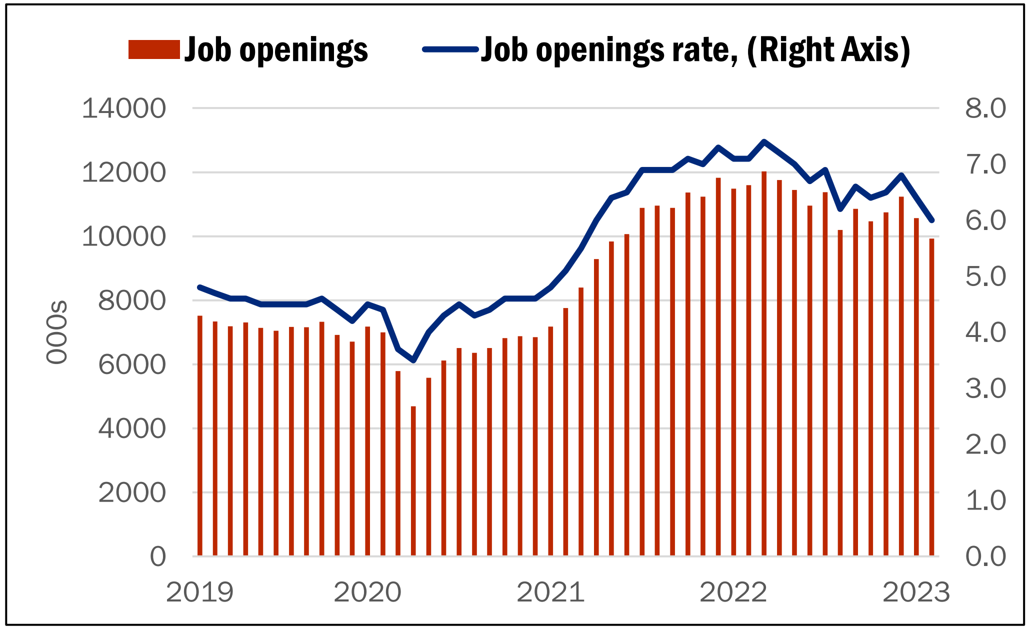
KEY DATES AND NEXT STEPS

OVERVIEW:

- US employment is slowing but the job market remains resilient with unemployment at near record lows and monthly job gains exceeding 200,000.
- Even with low unemployment, wage pressures are subsiding and prices are moderating. CPI data for March showed overall inflation up 5.0 percent compared to the previous year. Rent price increases may have finally begun to ease.
- The Fed however continues to signal that it remains committed to bringing inflation down to its target level and continued to raise rates at the March meeting.
- The recent banking crisis appears to be averted for now. Nonetheless, there are concerns that banks will curtail lending activity to shore up capital. Commercial property debt is creating more banking sector worries.
- Consumption has been slowing in recent months, particularly for purchases of goods.
- Virginia's employment growth has also slowed slightly in recent months. Virginia wage rate growth is slowing at a faster pace than the nation.
- Compared to the proposed December forecast, actual General Fund Revenues through March exceed projections by $124.2 million, a $13.0 million increase versus the February report.
- The current economic environment and outlook for a six- to nine-month recession beginning in early FY 2024 are consistent with assumptions underlying the December revenue forecast.

US EMPLOYMENT GROWTH IS SLOWING AND JOB OPENINGS ARE DECLINING BUT, WITH JOB GAINS AT OVER 200,000 PER MONTH, LABOR MARKETS REMAIN RESILIENT TO INCREASING INTEREST RATES.

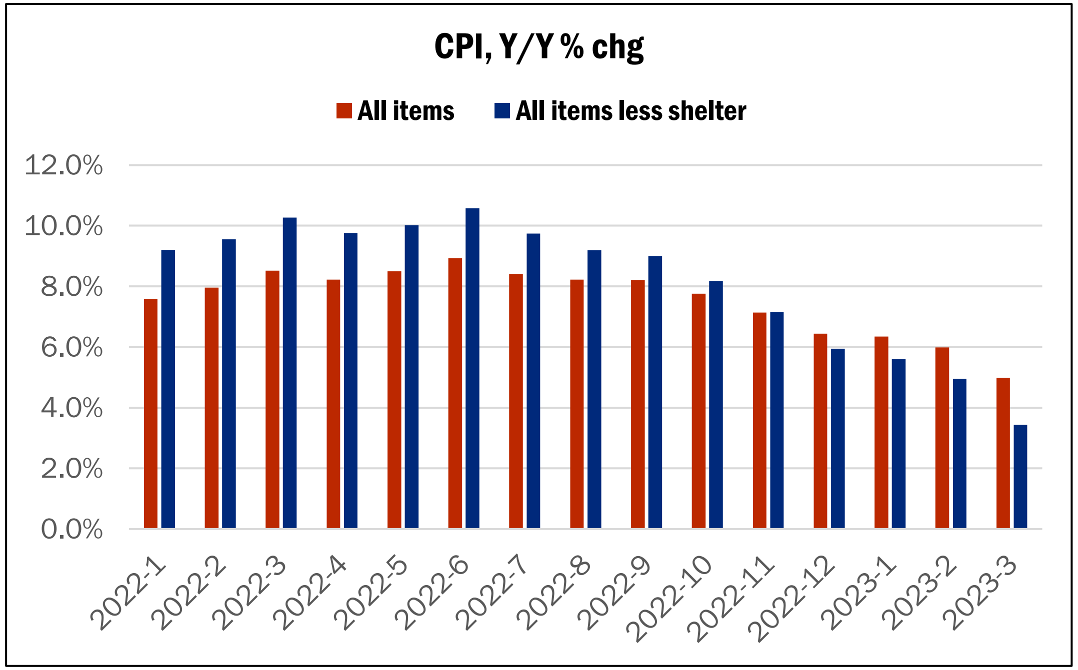


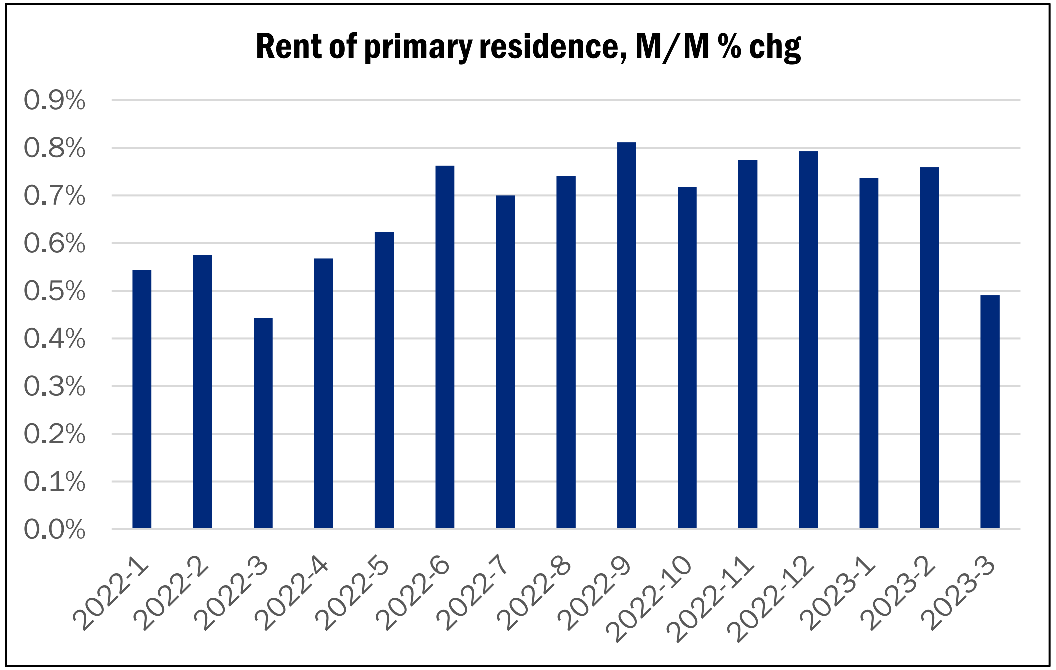


Sources: US BLS

- Even with the recent declines in openings, the jobs openings rate, the number of job openings as a percent of employment plus job openings, is currently at 6 percent, compared to 4 percent pre-pandemic.

CPI DATA FOR MARCH SHOWED THE SMALLEST INCREASE IN RENT PRICES IN 12 MONTHS. SHELTER PRICES (INCLUDING RENTS) HAVE BEEN KEEPING INFLATIONARY PRESSURES HIGH.

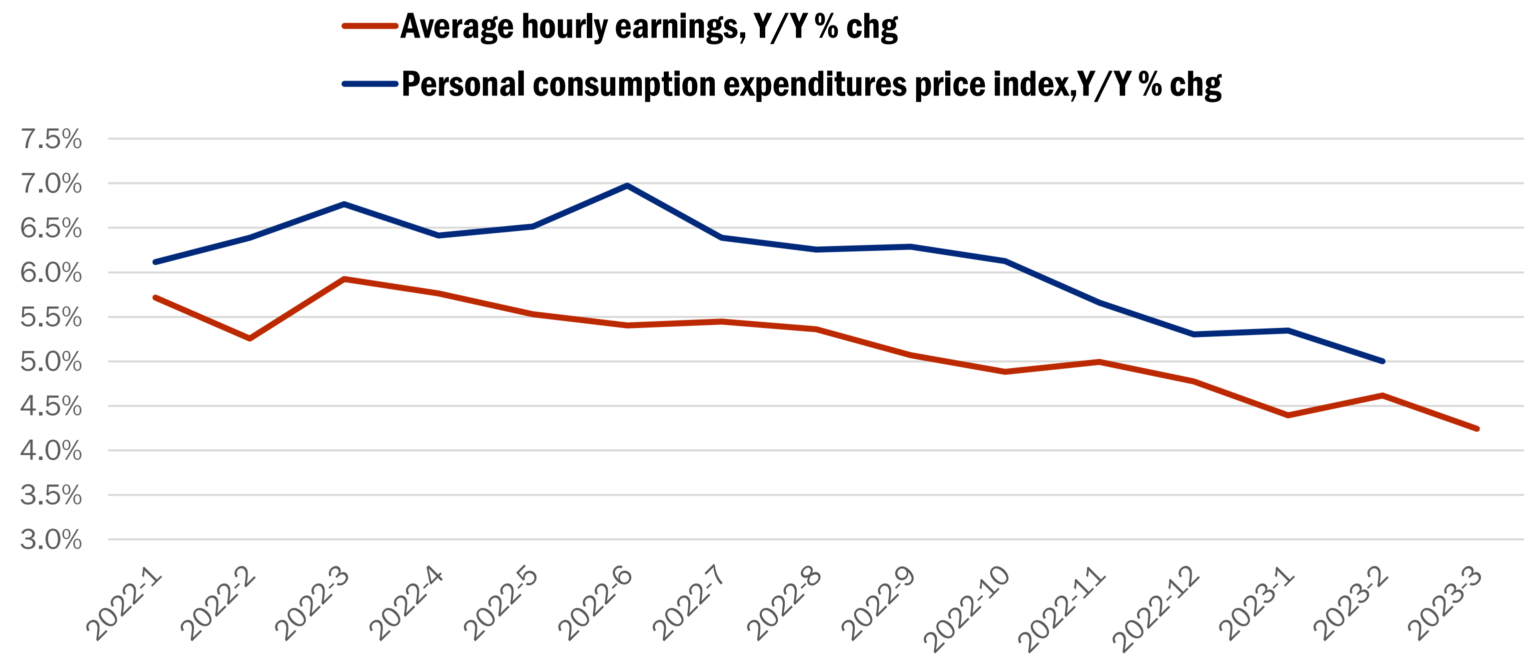




Sources: US BLS

- The monthly increases in the shelter component of CPI, which accounts for about one-third of the overall CPI index, slowed to 0.5% in March.
- The CPI for all items less shelter was up 3.4 percent year-over-year in March.

EVEN WITH TIGHT LABOR MARKETS, WAGES AND INFLATIONARY PRESSURES ARE SUBSIDING.



Sources: US BLS, U.S. BEA

The PCE Index is the Fed's "preferred" measure of inflation as it allows for substitution effects among items.

THE RECENT RUN-OFF OF DEPOSITS AT SMALL BANKS APPEARS TO HAVE BEEN CONTAINED FOR NOW, WITH DEPOSITS STABILIZING.

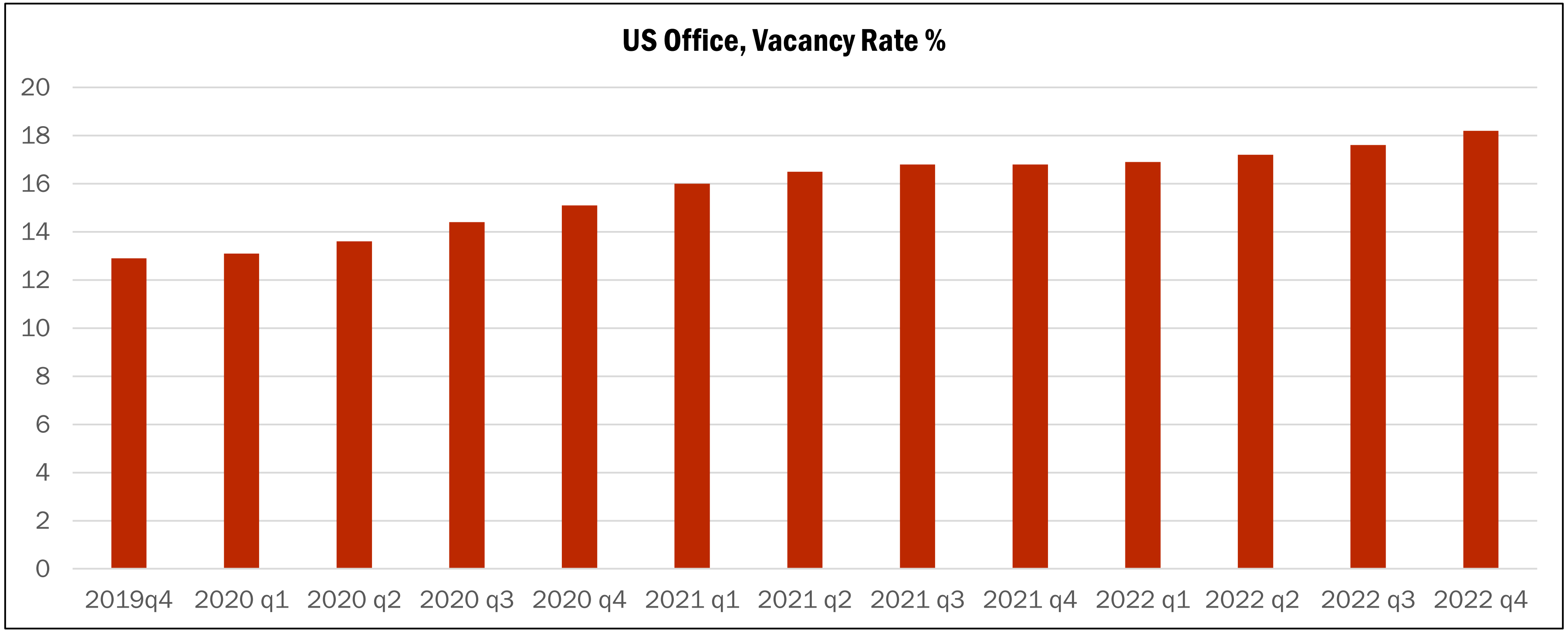
Liabilities of Small Domestically Chartered Commercial Banks in the United States, $ billions

									Week Ending			
	Feb-22	Aug-22	Sep-22	Oct-22	Nov-22	Dec-22	Jan-23	Feb-23	3/8/2023	3/15/2023	3/22/2023	3/29/2023
Deposits	5,543.8	5,572.5	5,572.3	5,565.9	5,552.7	5,602.3	5,598.8	5,590.3	5,576.9	5,380.6	5,340.1	5,341.6
Borrowings	220.4	278.3	300.1	327.1	351.9	395.8	409.0	415.5	415.1	738.8	714.5	590.1

Source: Federal Reserve Bank: Small domestically chartered commercial banks are defined as all domestically chartered commercial banks not included in the top 25.

- Increased short-term borrowings from the Fed have begun to decline.

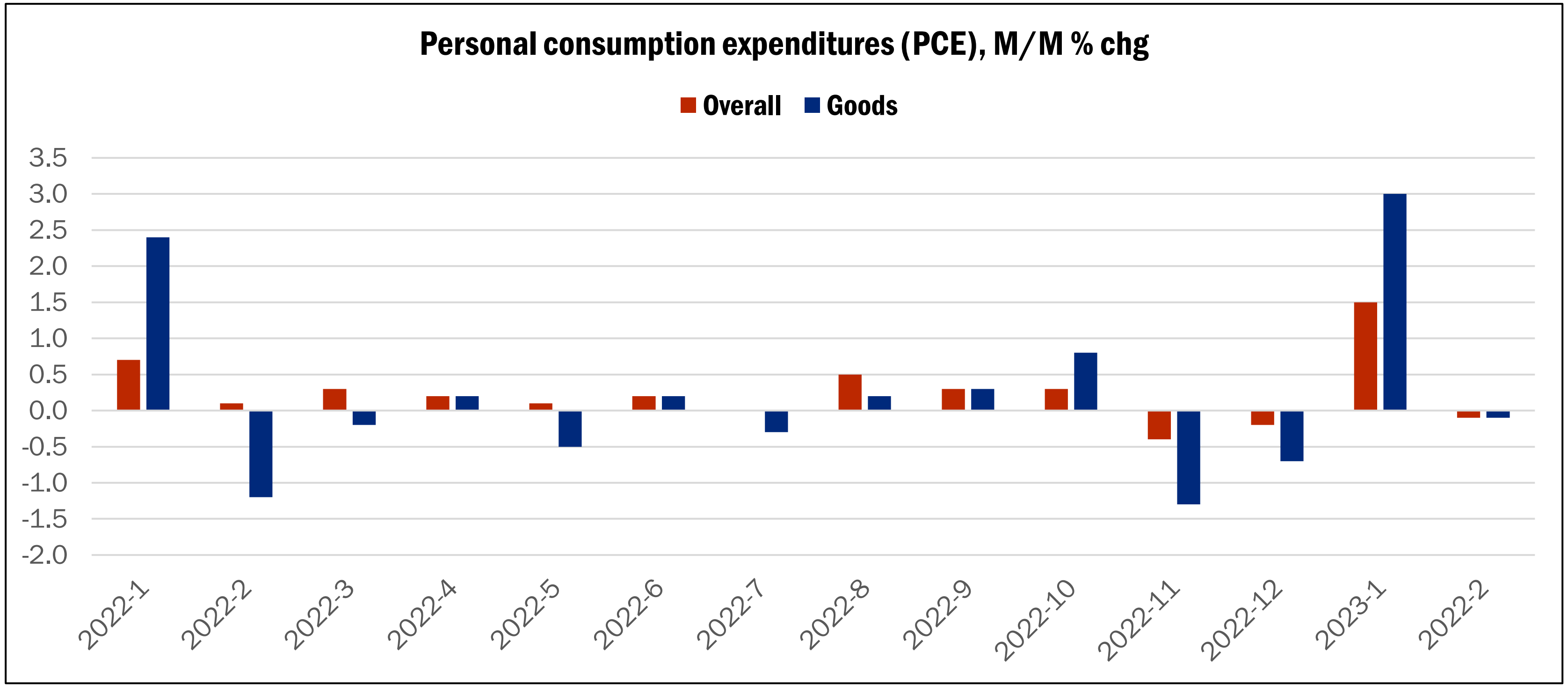
US OFFICE VACANCY RATES HAVE SOARED SINCE THE PANDEMIC DUE TO DECREASED DEMAND FOR OFFICE SPACE RESULTING FROM WORK FROM HOME. COUPLED WITH HIGHER INTEREST RATES, THIS HAS RAISED CONCERN THAT DEFAULTS MAY BE LOOMING.



Source: Cushman and Wakefield, Goldman Sachs

- Office CMBS issuance has come to a virtual standstill in recent months, down 94 percent y/y in the past 3 months.

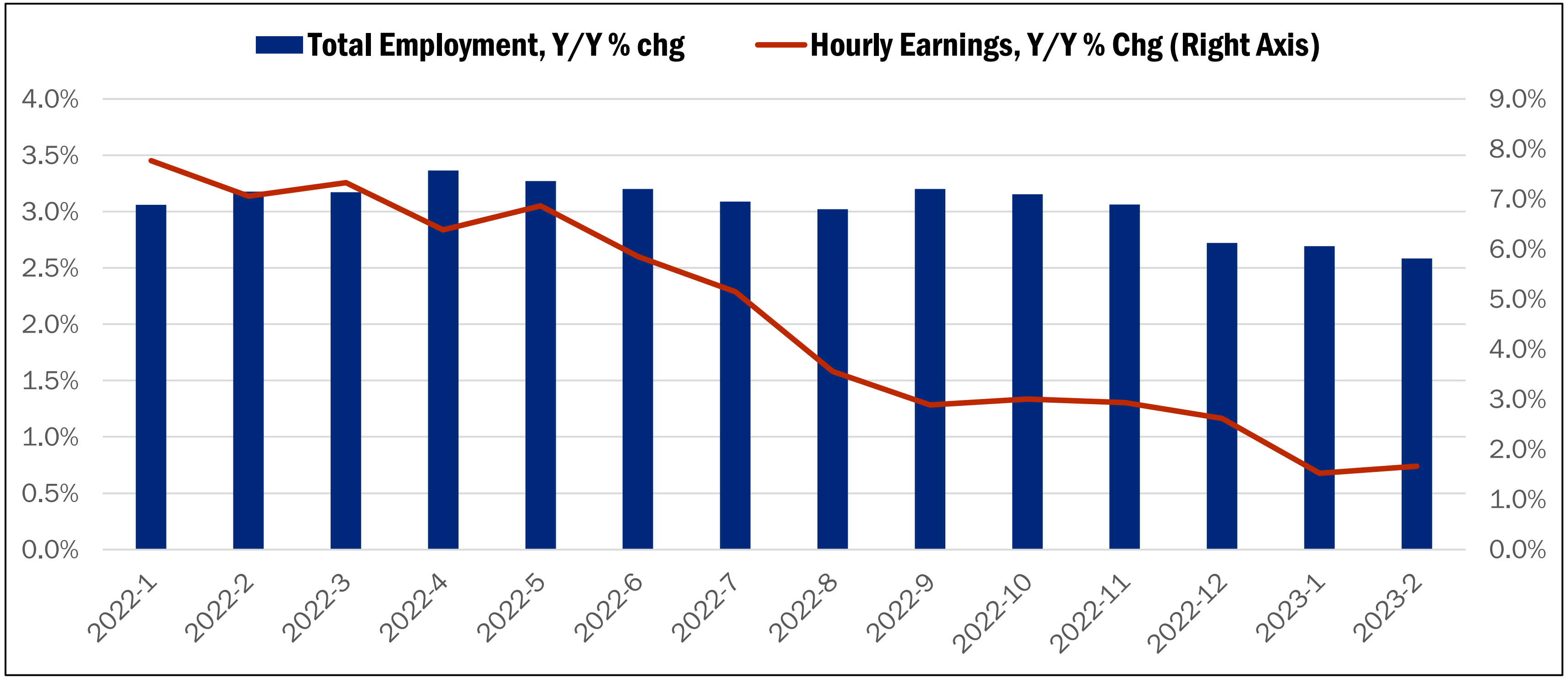
PERSONAL CONSUMPTION HAS DECLINED IN 3 OF THE LAST 4 MONTHS. CONSUMPTION OF GOODS HAS FALLEN IN 7 OF THE PAST 12 MONTHS.



Sources: US BEA

- The shift in consumption patterns to services has implications for Virginia sales tax revenue. See slide 19.

VIRGINIA'S EMPLOYMENT GROWTH HAS SLOWED ONLY SLIGHTLY IN RECENT MONTHS. THE DECLINE IN WAGE EARNINGS GROWTH HAS BEEN MORE PRONOUNCED.



Sources: US BLS, CES Survey

COLLECTION TRENDS MARCH FISCAL YEAR-TO-DATE SUMMARY:

- Relative to the updated December forecast, unadjusted general fund revenues are ahead of forecast by $124.2 million year-to-date through March.
- Among the major revenue sources, after adjustments for timing and policy actions, withholding is 7.7 percent higher fiscal year-to-date, slightly below forecast. Sales tax revenue is 4.8 percent higher fiscal year-to-date, weaker than expected.
- March is not a significant month for non-withholding. As the deadline for the filing season approaches, year-to-date collections are 2.5 percent higher after adjustments.
- Refunds, which totaled $574 million in March, were considerably higher than the $390 million issued last March, but in line with projections for the month. The expanded EITC credit, along with the increased standard deduction and military retirement subtraction, added about $83 million to refunds.
- Corporate income taxes are running 6.3 percent lower fiscal year-to-date compared to the previous year. All other sources of revenue are 13.0 percent higher with strength in interest income offsetting weakness in wills and deed recordation taxes.
- To-date, interest income exceeds the full year forecast by about $91 million.
- On an unadjusted basis versus prior year, total general fund revenues were up 0.6 percent fiscal year-to-date and down 3.8 percent for the month of March, mainly due to increases in refunds.

ON AN UNADJUSTED BASIS, GF REVENUES WERE 3.8 PERCENT LOWER IN MARCH. YEAR-TO-DATE, COLLECTIONS ARE UP 0.6 PERCENT, AHEAD OF THE DECEMBER ESTIMATE.

	FY 2023	Pct Chg	Percent of	MARCH				Fiscal Year-To-Date				Year-To-Date
Unadjusted Revenues	**December**	**Req by Est**	**GF Rev**	**FY 2022**	**FY 2023**	**Change**	**% Change**	**FY 2022**	**FY 2023**	**Change**	**% Change**	**% of Total**
Withholding	16,078.3	4.8%	60.9%	1,595.5	1,640.2	44.8	2.8%	11,541.3	12,053.6	512.3	4.4%	64.2%
Nonwithholding	5,088.6	-25.3%	19.3%	384.4	369.5	(14.8)	-3.9%	2,549.1	3,284.3	735.2	28.8%	17.5%
Refunds	(3,535.2)	103.1%	-13.4%	(389.8)	(574.5)	(184.7)	47.4%	(1,050.4)	(2,536.5)	(1,486.2)	141.5%	-13.5%
Sales and Use Tax	4,926.3	8.1%	18.7%	337.4	331.0	(6.4)	-1.9%	3,266.3	3,545.2	278.9	8.5%	18.9%
Corporate Income Tax	1,809.1	-8.6%	6.9%	69.8	127.5	57.7	82.6%	1,166.9	1,093.1	(73.8)	-6.3%	5.8%
All Other Sources	2,020.7	1.7%	7.7%	122.2	144.8	22.6	18.5%	1,180.0	1,333.3	153.2	13.0%	7.1%
Total GF Revenues	**$26,387.8**	**-8.8%**	100.0%	**$2,119.4**	**$2,038.6**	**($80.8)**	**-3.8%**	**$18,653.3**	**$18,773.0**	**$119.6**	**0.6%**	**100.0%**

Adjusted Revenues	FY 2022	FY 2023	Change	% Change	FY 2022	FY 2023	Change	% Change
Adjusted Withholding	1,595.5	1,708.2	112.7	7.1%	11,541.3	12,425.4	884.1	7.7%
Adjusted Non-Withholding (PTET)					2,549.1	2,613.5	64.4	2.5%
Adjusted Refunds+Rebates	(389.8)	(491.6)	(101.8)	26.1%	(1,050.4)	(1,396.5)	(346.1)	32.9%
Adjusted Sales (AST+ Grocery Tax)*	337.4	350.1	12.8	3.8%	3,469.7	3,637.6	167.8	4.8%
Total GF Revenues, Adjusted	**$2,119.4**	**$2,189.4**	**$70.0**	**3.3%**	**$18,856.7**	**$19,486.0**	**$629.2**	**3.3%**

*$ mil, * Sales tax adjustment also includes the exemption for veterinary products*

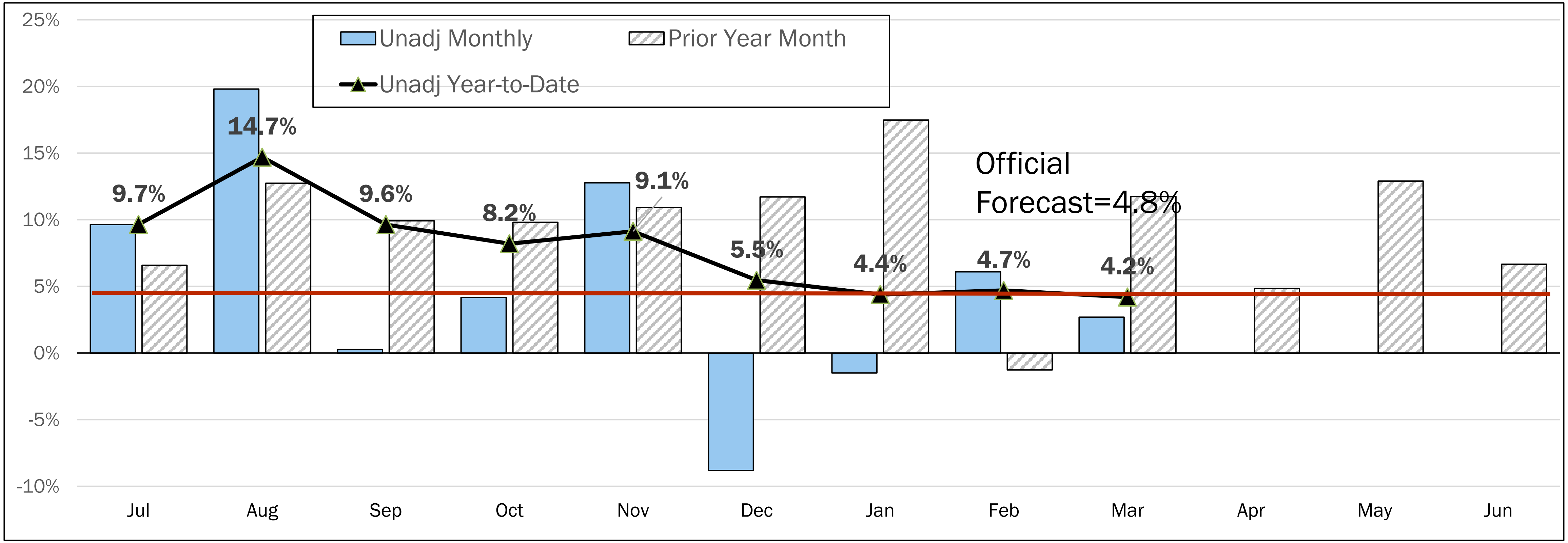
- March's year-over-year sizeable decline is the result of higher refunds due to the expanded EITC, increased standard deduction, and military retirement subtraction. The elimination of the state sales tax on groceries also subtracted $19 million in revenues.
- On an adjusted basis, revenues were up 3.3 percent for the month and are also 3.3 percent higher year-to-date.

MARCH COLLECTIONS CAME IN $13.0 MILLION HIGHER THAN PROJECTED AND YEAR-TO-DATE COLLECTIONS ARE $124.2 MILLION AHEAD OF FORECAST.

	March					FYTD				
SOURCE, $Mil	Actuals	Projected	Variance	PY	Y/Y %	Actuals	Projected	Variance	PY	Y/Y%
Withholding	1,640.2	1,642.4	(2.2)	1,595.5	2.8%	12,053.6	12,085.9	(32.3)	11,541.3	4.4%
Non-withholding	369.5	342.0	27.5	384.4	-3.9%	3,284.3	3,136.2	148.1	2,549.1	28.8%
IIT Refunds	(574.5)	(584.9)	10.4	(389.8)	47.4%	(2,536.5)	(2,525.1)	(11.5)	(1,050.4)	141.5%
Net	1,435.3	1,399.6	35.7	1,590.0	-9.7%	12,801.4	12,697.1	104.3	13,040.0	-1.8%
Sales/Use	331.0	361.9	(31.0)	337.4	-1.9%	3,545.2	3,605.3	(60.1)	3,266.3	8.5%
Corporate	127.5	128.9	(1.3)	69.8	82.6%	1,093.1	1,125.5	(32.4)	1,166.9	-6.3%
All other	144.8	135.2	9.6	122.2	18.5%	1,333.3	1,220.8	112.5	1,180.0	13.0%
Total GF Revenues	2,038.6	2,025.6	13.0	2,119.4	-3.8%	18,773.0	18,648.7	124.2	18,653.3	0.6%

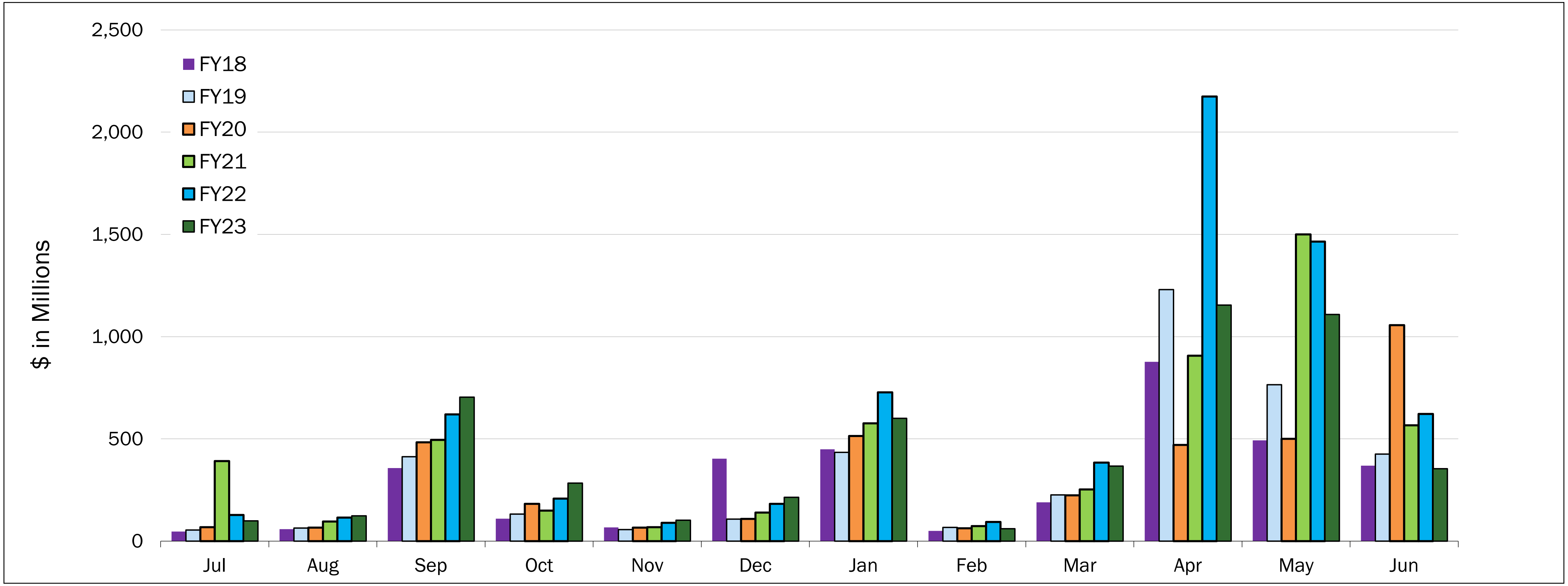
- The positive variance is mainly due to higher than expected collections for non-withholding and All Other (interest income).

WITHHOLDING YTD THROUGH MARCH IS RUNNING SLIGHTLY BELOW FORECAST DUE TO WEEKLY TIMING ISSUES WHICH ARE NOT EXPECTED TO IMPACT YEAR-END RESULTS.



- The slowdown in withholding is consistent with our expectations of decelerating employment growth and the impact of the increased standard deduction.
- The amount required to meet the estimate for the remaining 13 weeks of the FY, $310 million on average, falls within the pattern of recent collection trends.

AS THE FILING DEADLINE APPROACHES, NON-WITHHOLDING TAX COLLECTIONS, AFTER ADJUSTING FOR THE PTET AND STANDARD DEDUCTION, ARE RUNNING 2.5 PERCENT HIGHER YEAR-TO-DATE COMPARED TO A FORECAST OF A 25 PERCENT DECLINE.



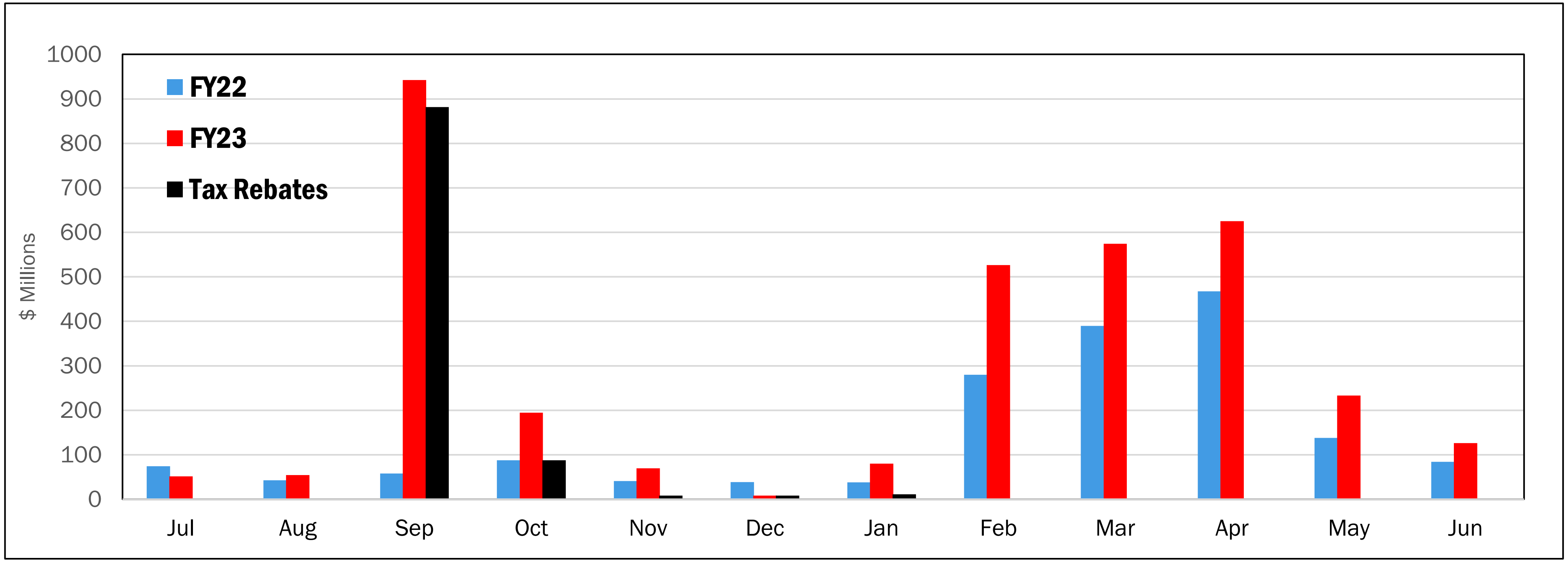
April-June 2023 data are estimates.

NON-WITHHOLDING, AFTER ADJUSTING FOR POLICY IMPACTS, CAN DECLINE BY 33 PERCENT FROM APRIL TO JUNE COMPARED TO THE PREVIOUS YEAR, AND STILL MEET THE ESTIMATE.

	Amount required to meet forecast Apr 2023-Jun 2023, $ mil	Apr 2022-Jun 2022, $ mil	Percent decline to meet estimate
Non-Withholding	$1,804	$4,261	-58%
Policy Impacts (Standard deduction, PTET)	$1,040	NA	NA
Net of Policy	$2,844	$4,261	-33%

- The 33 percent decline would exceed the declines experienced in both 2002 and 2008.

THE FILING SEASON IS UNDERWAY AND, AS EXPECTED, REFUNDS IN FEBRUARY AND MARCH WERE SIGNIFICANTLY HIGHER DUE TO THE INCREASED STANDARD DEDUCTION, EXPANDED EITC, AND THE MILITARY RETIREMENT SUBTRACTION.



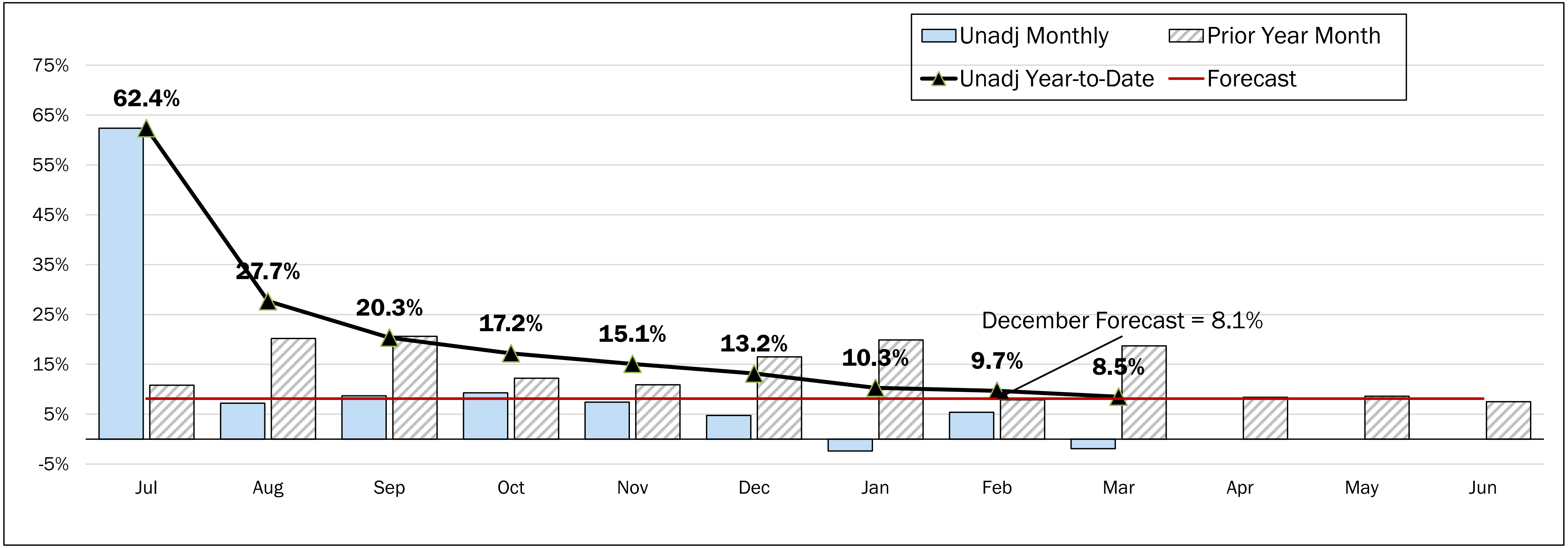
- Refunds almost doubled in February and March compared to the prior year due to the increased standard deduction and the expanded EITC. April-June 2023 refunds are estimates.

BOTH THE NUMBER OF REFUNDS ISSUED AND AVERAGE AMOUNTS ARE HIGHER THIS FILING SEASON DUE TO THE INCREASED STANDARD DEDUCTION, THE EXPANDED HIGHER EITC, AND THE MILITARY RETIREMENT SUBTRACTION.

FY	Total Refunds Issued #	Total Amount $	Avg Amount $
2022	1,308,373	$663,417,405	$507
2023	1,621,381	$1,077,310,390	$664

Refund data is for February and March combined

UNADJUSTED SALES TAX COLLECTIONS GREW BY 8.5 PERCENT YEAR-TO-DATE, MAINLY DUE TO THE END OF THE AST PROGRAM IN FY 2022.



- Growth in sales tax revenue will continue to slow due to the elimination of the sales tax on groceries and the full impact of the AST in June. The shift to consumption of services, which are largely tax exempt, also is a drag on sales tax revenue growth.

OTHER SOURCES:

- Corporate income tax revenues are 6.3 percent lower year-to-date, which is less than anticipated.
- Deed recordation taxes are also down sharply, by 34.6 percent year-to-date, reflecting weakening demand for housing and commercial properties.
- Other Revenues are offsetting the weakness in corporate tax and deed tax revenues, exceeding projections by $112.5 million, mainly due to higher interest income.
- Interest income totals $313.3 million in the first nine months of the year, compared to a full year forecast of $222.6 million.

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COLLECTIONS SUMMARY AND KEY UPCOMING DATES

- As we approach the tax year filing deadline, year-to-date collections are running ahead of the December updated projections by $124.2 million.
- Among major sources, growth in withholding collections is slowing, but the slowdown is largely anticipated in the forecast.
- Sales tax collections are running lower than forecast. The shift in consumption patterns to non-taxable services has curtailed revenue growth.
- There is still considerable uncertainty surrounding final payments due in April and May, and refunds.
- The weakness in corporate and deed recordation revenue is being offset by higher interest income.
- The December forecast provides for a significant decline in non-withholding revenues and assumes a slowdown in the growth other revenue sources.
- As such, we remain confident in our outlook and the availability of the necessary resources to provide meaningful tax relief while addressing the needs for behavioral health reform, economic development, public safety, education and other spending priorities.