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: October Revenue Report

For the month of October, total general fund revenues fell by 4.6 percent compared to October 2022, mainly reflecting an increase in individual income tax refunds. The increase in refunds is primarily due to higher individual income tax refunds resulting from the 2022 increase in the standard deduction and continuing elevated refunds of individual income tax overpayments related to the elective Pass-Through Entity Taxes (PTET) in Fiscal Year 2023.

With four months of collections, Fiscal Year 2024 unadjusted revenues are up 12.1 percent year-to-date and are ahead of projections based on the forecast assumed in the amended budget (Chapter 1) adopted in September. Major revenue sources are generally in line with or exceed expectations. However, PTET-related activity in non-withholding collections and refunds continue to distort overall revenue collections.

Excluding non-withholding collections and refunds, general fund collections are up 4.4 percent year-to-date versus a projected increase of 0.9 percent for the first four months of the fiscal year. The two sources most closely tied to current economic activity, withholding and sales tax, are in line with projections with variances to projections of 2.1 percent and 1.0 percent, respectively, through October.

Among the other major revenue sources, corporate income tax collections grew 68.3 percent in October. For the full fiscal year, corporate income tax collections are forecast to decline 6.6 percent. Higher corporate tax refunds are anticipated in November which will temper year-to-date growth.

Adjusting for policy and excluding PTET-related refunds to better reflect underlying economic growth, total general fund revenues decreased 5.3 percent year-over-year in October and are up 1.8 percent year-to-date. Adjusted withholding collections grew 6.3 percent in October and are up 4.5 percent for the year, while adjusted sales tax collections increased 0.9 percent in October and are up 2.1 percent year-to-date.

For the full fiscal year, the official revenue forecast anticipates a year-over-year decline in general fund revenues of 5.5 percent, including the impact of various tax policy actions adopted in 2022 and 2023, and reflecting the potential for an economic slowdown in the latter part of the current fiscal year. With the possibility of a recession in the second half of Fiscal Year 2024, revenue growth is expected to moderate over the balance of the fiscal year.

Economic Review

- The U.S. economy continues to show remarkable resilience even as interest rates have increased significantly. Real GDP rose a robust 4.9 percent in the third quarter of calendar year 2023 on a seasonally adjusted annual rate, more than double the second quarter rate. This was the strongest growth since the final three months of 2021. Inventory growth contributed meaningfully, though not as much as the strong consumer spending. Compared to the same quarter last year, Real GDP grew 2.9 percent in the third quarter.

- The October labor report showed a much more subdued picture of the US job market. Payroll employment rose by just 150,000, partly weighed down by the now-ended UAW strike. The unemployment rate increased to 3.9 percent in October as both the labor force and employment dropped. October's job report marks a return to the moderating trend seen throughout calendar year 2023. Payroll increases are now averaging 204,000 over the last three months after downward revisions to the August and September figures.

- In September, the Consumer Price Index (CPI) was up 3.7 percent year-over-year, the same as it was in August. Excluding food and energy prices, September's CPI data came in as expected and show a continuation of the steady disinflation that began in late 2022. Relative to a year earlier, core CPI was up 4.1 percent in September, a healthy deceleration from August's 4.3 percent pace.

- At its November 1 meeting, the Federal Reserve maintained the target for the federal funds rate at a range of 5.25% to 5.50%, as expected. The accompanying statement noted that "economic activity expanded at a strong pace in the third quarter," that "job gains have moderated since earlier in the year but remain strong, and the unemployment rate has remained low," and that "inflation remains elevated."

- Virginia's unemployment rate was unchanged at 2.5 percent on a seasonally adjusted basis in September which is 0.5 percentage points below year-ago rates. The labor force participation rate increased to 66.8 percent in September.

- Virginia's nonagricultural employment from the monthly establishment survey decreased month-over-month by 100 to 4.16 million in September. Private sector employment increased by 3,500 while government employment decreased by 3,600. On a year-over-year basis, Virginia employment grew 1.2 percent in September compared to September 2022, continuing the trend of decelerating year-over-year job growth.

- The economy faces significant potential headwinds that suggest the possibility of a U.S. recession in calendar year 2024, including a possible federal government shutdown, persistently high interest rates, possible regional spillover of the military operations in Gaza, an economic slowdown in China, the resumption of student loan payments, and the spend down of pandemic savings.

October Revenue Collections

General fund revenues fell by 4.6 percent for the month of October on an unadjusted basis. Year-to-date through October 31, general fund revenues are up 12.1 percent over the prior year. Adjusting for policy actions and excluding refunds related to the Pass-Through Entity Tax (PTET), October revenues declined by 5.3 percent year-over-year in October and are up 1.8 percent year-to-date.

Net Individual Income Tax (67% of general fund revenues): Unadjusted revenues declined by 4.4 percent for the month compared to last year, reflecting the impact of higher individual refunds attributable to PTET overpayments. Year-to-date net individual income tax collections are up 12.5 percent. Compared to the forecast assumed in the amended budget, year-to-date net individual income tax collections are ahead of projections by $720.9 million, driven by PTET-related non-withholding receipts and lower-than-expected individual income tax refunds.

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

Individual Income Tax Withholding (60% of general fund revenues): Collections of payroll withholding taxes were 2.6 percent higher for the month on an unadjusted basis. Fiscal-year-to-date, collections are 4.5 percent higher than the same period last year after adjustments, and up 1.0 percent on an unadjusted basis. Compared to the Forecast assumed in Chapter 1, withholding revenues are ahead by $104.3 million year-to-date.

Individual Income Tax Non-withholding (18% of general fund revenues): October is not a significant month for non-withholding receipts. October collections increased by 2.5 percent and are up 6.5 percent for the year, both on an unadjusted basis. Through the first four months of the fiscal year, non-withholding receipts are $323.4 million ahead of forecast.

Individual Income Tax Refunds (-11% of general fund revenues): In October, individual income tax refunds were up 51.7 percent. However, in October 2022, $88.1 million in refunds were the result of the taxpayer rebate. Adjusting for the taxpayer rebate program of Fiscal Year 2023, refunds were up 177.0 percent driven by refunds attributed to prior year PTET overpayments.

Sales Tax (17% of general fund revenues): Collections of sales and use taxes, reflecting September sales, grew by 0.9 percent in September and are up 2.1 percent year-to-date, after adjusting for the elimination of the State sales tax on grocery and the end of the Accelerated Sales Tax requirement. Unadjusted sales tax collections are 0.3 percent higher year-to-date, in line with expectations.

Corporate Income Tax (7% of general fund revenues): Corporate income tax collections continue to show robust growth. Monthly collections increased by 68.3 percent and year-to-date growth is at 24.4 percent. Corporate extension returns are expected to show a higher level of refunds in November that is expected to temper October's robust collections. Compared to forecast, corporate income tax collections are ahead of plan by $113.9 million year-to-date.

Wills, Suits, Deeds, Contracts (1% of general fund revenues): Collections of wills, suits, deeds, and contracts – mainly recordation tax collections – were 11.1 percent lower in October compared to the previous year. On a fiscal-year-to-date basis, collections are down 20.5 percent as higher interest rates have sharply curtailed residential and commercial property sales and mortgage refinancing.

Insurance Premiums (2% of general fund revenues): Monthly collections of insurance company premiums license taxes are being transferred to the Transportation Trust Fund per Chapter 986, 2007 Acts of the Assembly, until the required amount of $217.8 million has been deposited.

Other Revenue Sources

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

	Year-to-Date	**Annual Estimate**
Interest Income (0.8% GF revenues)	*226.6%*	*73.9%*
ABC Taxes (1% GF revenues)	*16.7%*	*3.7%*

October marks the first quarterly distribution of interest to non-general fund sources. Net interest income was -$42.4 million in October, considerably lower than the $3.6 million last October.

All Other Revenue (2% of general fund revenues): October receipts were modestly lower in this source. On a year-to-date basis, collections of All Other Revenue declined by 3.7 percent to $153.4 million fiscal year-to-date compared with $159.3 million a year ago.

Summary

Through the first four months of fiscal year 2024, year-to-date collections are up 12.1 percent compared to last year and are running ahead of projections assumed in the amended budget. All of the major sources are generally in line or ahead of projections. Adjusting for policy and excluding PTET-related refunds to better reflect underlying economic growth, total general fund revenues are up 1.8 percent year-to-date.

We had anticipated that taxpayers with pass-through entity income would adjust individual income tax estimated payments as they shift their liabilities to the pass-through level. While data limitations continue to be a challenge in tracking and forecasting PTET-related activity, improved internal Department of Taxation data indicate this shift in taxpayer behavior did not occur as estimated. Given that the first PTET-related payments were not received until December 2022, the next guidepost we will have in evaluating non-withholding will be after the January 15, 2024, estimated payment due date. Furthermore, the level of individual income tax refunds that had been anticipated due to PTET overpayments in fiscal year 2023 while higher has, to this point, been less than expected.

The fall revenue forecasting season that began with a meeting of the Governor's Advisory Council on Revenue Estimates on August 7, continued with the Joint Advisory Board of Economists meeting on October 11. The second meeting of the Governor's Advisory Council on Revenue Estimates will be on November 20. Given the aforementioned downside economic risks and the possibility of a recession occurring in calendar year 2024, we continue to maintain a cautious outlook for economic growth and revenue collections going forward. The revised forecast for fiscal year 2024 and revenue forecasts for fiscal years 2025 and 2026 will accompany the Governor's proposed budget which will be released on December 20.