COMMONWEALTH of VIRGINIA

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Secretary of Finance

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June 13, 2023

MEMORANDUM

TO: The Honorable Glenn Youngkin

THROUGH: The Honorable Jeff Goettman

FROM: Stephen E. Cummings

SUBJECT: May Revenue Report

With one month left in fiscal year 2023, general fund revenues are ahead of the updated December forecast ("the Forecast") by $948.0 million year-to-date. Most of the increase above Forecast is the result of differences in the timing of events anticipated in the Forecast. Absent these timing differences, revenues are modestly ahead of Forecast, providing an added buffer to prepare the Commonwealth for any recession that may occur in FY 2024. Accordingly, Finance remains confident with the Forecast in your introduced budget.

The two key timing differences relate to the newly enacted Pass-Through Entity Tax (PTET), and the recession anticipated in the Forecast. As you know, the PTET provided a way for owners of unincorporated businesses to deduct state and local taxes (SALT) above the Federal limit of $10,000 per year. Business owners pay the PTET to the Commonwealth at the entity level, which yields a business expense at the Federal level, and receive a dollar-for-dollar credit at the individual level on the Virginia income tax. There is no net impact on revenues to the Commonwealth. However, given that the payments and refunds will occur over two fiscal years, there is a significant impact on our annual numbers. The Forecast anticipated that approximately $600 million in PTET credits would have been available for use this fiscal year, but processing delays and filings for extensions have pushed the use of those credits to fiscal year 2024.

Similarly, the Forecast anticipated that the United States would slip into a recession in the first half of calendar year 2023. The Administration's current economic outlook continues to anticipate that this credit tightening cycle will end with a mild recession, but that the recession will now occur during fiscal year 2024.

Year-over-year revenues are down 3.4 percent fiscal year-to date. For the month of May alone, the overall decline in revenues was 21.0 percent, driven by sharply lower non-withheld income tax receipts, which fell by almost 50 percent. This was primarily due to the significant shift of tax payments from May to April as a result of the earlier income tax filing deadline for PTET, leading to significant variances for both May and April compared to the previous year. For the April-May period combined, which accounts for the timing shift, non-withholding collections were down by 25.0 percent, a significantly smaller decline than had been anticipated in our forecast.

Among other major sources, withholding was $41.1 million lower than forecast in May. Sales tax revenue was down by almost $70 million. As indicated in prior reports, shifting consumer patterns away from taxable goods, along with weaker overall consumption, have contributed to a larger than anticipated decline in this source of revenue. Overall collections from other sources of revenues generally exceeded the Forecast as discussed in more detail in the following sections.

Compared to the amended 2022 Appropriation Act (Chapter 769) revenues exceed projection by $2.3 billion year-to-date. Throughout the remainder of this memorandum, all revenue comparisons will be against prior year or the December Forecast.

Economic Review

- The U.S. economy continues to show resilience even as interest rates have increased significantly over the past year. U.S. Employers continued to increase payrolls in May at a surprisingly strong pace of 339,000 jobs.

- Job gains in low-paying sectors of the economy that were most severely impacted during the shutdown continue to rebound strongly in both the nation and in Virginia.

- Average wage gains are slowing, driven largely by growth in lower paying jobs. Adjusting for the shift in job mix to account for the higher rate of growth in low-paying jobs, the slowdown is more moderate.

- The Federal Reserve is expected to pause increasing rates at its June 13th meeting as it assesses more data on inflation. However, officials have signaled that if inflation does not trend downwards convincingly, they will continue to raise rates.

- The U.S. avoided a debt default by striking a deal that suspends the debt limit for two years. The impact on the overall U.S. and Virginia economy is expected to be minor in FY 2024. Spending caps on discretionary spending in FY 2024 are relatively moderate after factoring in adjustments. Defense spending is unchanged compared to the President’s proposed budget.

May Revenue Collections

In May, general fund revenues were down 21.0 percent on an unadjusted basis and down 17.8 percent after adjusting for policy actions and timing issues. With one month remaining in the fiscal year, year-to-date unadjusted general fund revenues are down 3.4 percent versus the projected 8.8 percent decline assumed in the Forecast.

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 declined 1.0 percent. Unadjusted revenues fell by 28.1 percent on a monthly basis and were down 7.3 percent year-to-date. This was mainly due to the $1.06 billion in tax rebates issued this year along with the substantial decline in non-withholding. 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 3.1 percent higher for the month on an unadjusted basis. Fiscal-year-to-date, collections are 6.7 percent higher than the same period last year after adjustments, and 4.1 percent on an unadjusted basis. Through May, collections are trailing projections by $112.4 million. The slowdown that has occurred in withholding growth since the beginning of the year is slightly more pronounced than anticipated in our economic and revenue Forecast which calls for 4.8 percent growth in Fiscal Year 2023 on an unadjusted basis.

Individual Income Tax Non-withholding (19% of general fund revenues): Non-withholding receipts again surprised to the upside in May. Given Virginia's May 1 income tax deadline, the flow of non-withholding between April and May varies from year to year. To properly assess collections in this source, April and May collections are considered together. Over the two-month period, collections fell by almost 25.0 percent, a much smaller decline than anticipated and smaller than the decline of 38.8 percent seen in the nation from federal income tax returns. After adjusting for the newly enacted PTET, collections are running 11.2 percent lower fiscal year-to-date. Fiscal year-to-date through May non-withholding collections are $1,060.4 million higher than projected.

Individual Income Tax Refunds (-13% of general fund revenues): Through May, the Department of Taxation has issued over $3.4 billion in refunds compared with $1.7 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 26.1 percent fiscal-year-to-date, $83.7 million higher than projected.

Sales Tax (19% of general fund revenues): Collections of sales and use taxes, reflecting April sales, declined by 0.7 percent in May and are up 3.1 percent year-to-date, after adjusting for the termination of the Accelerated Sales Tax (AST) program and the elimination of the State sales tax on groceries. Unadjusted sales tax collections are 6.0 percent higher year-to-date, but trail year-to-date projections by $185.8 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 grew by 12.0 percent for the month of May, continuing the positive upside surprise of the previous month. On a year-to-date basis, collections of corporate income taxes are 1.4 percent higher compared to the previous year, compared with a projected decline of 8.6 percent in the Forecast, and ahead of projections by $112.5 million. There are no policy actions impacting revenue collections.

Wills, Suits, Deeds, Contracts (2% of general fund revenues): Collections of wills, suits, deeds, and contracts – mainly recordation tax collections – were 33.4 percent lower in May compared to the previous year. On a fiscal-year-to-date basis, collections are down 35.2 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 were down 42.6 percent compared to the previous year. On a fiscal year-to-date basis, insurance company premiums are up 4.1 percent.

Other Revenue Sources

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

	Year-to-Date	**Annual Estimate**
Interest Income (0.8% GF revenues)	382.0%	190.4%
ABC Taxes (1% GF revenues)	2.7%	3.6%

Interest income has almost quadrupled through May compared to the previous year, totaling $392.8 million in the first ten months of the year compared to the 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 20.0 percent to $476.4 million fiscal year-to-date compared with $396.9 million a year ago.

Summary

Year-to-date collections are now running ahead of projections by $948.0 million, mainly due to higher than anticipated non-withholding revenue. Revenues from most sources generally exceed the Forecast, although the major sources of withholding and sales tax collections are trailing projections. Timing shifts with respect to PTET and the onset of the Administration's expected recession at the end of this credit tightening cycle account for virtually all the higher revenues year-to-date. Finance remains confident about the Forecast in your introduced budget and will continue to carefully monitor economic and revenue collection data as we begin to develop the budget for the 2024-2026 biennium.