ECONOMIC AND REVENUE REVIEW AND UPDATE

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

TOPICS FOR DISCUSSION

ECONOMIC UPDATE

MAY FISCAL YEAR-TO-DATE REVENUE COLLECTIONS

COLLECTION BY MAJOR SOURCES AND DRIVERS

KEY DATES AND NEXT STEPS

OVERVIEW:

- The US economy continues to show resilience even as interest rates have increased significantly over the past year. 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 moderating but adjusting for industry mix to account for the higher rate of growth in low-paying jobs, wage gains are still fairly elevated.
- 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 US avoided a debt default by striking a deal that suspends the debt limit for two years. The impact on the overall US and VA 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.
- Revenue collections continued to exceed projections, due primarily to strength in non-withholding. Overall revenues exceed projections by $948 million fiscal year-to-date.
- These results, however, are overstated by timing issues related to the newly enacted Pass-Through Entity Tax (PTET) which are expected to reduce revenues in FY 2024 by approximately $600 million.

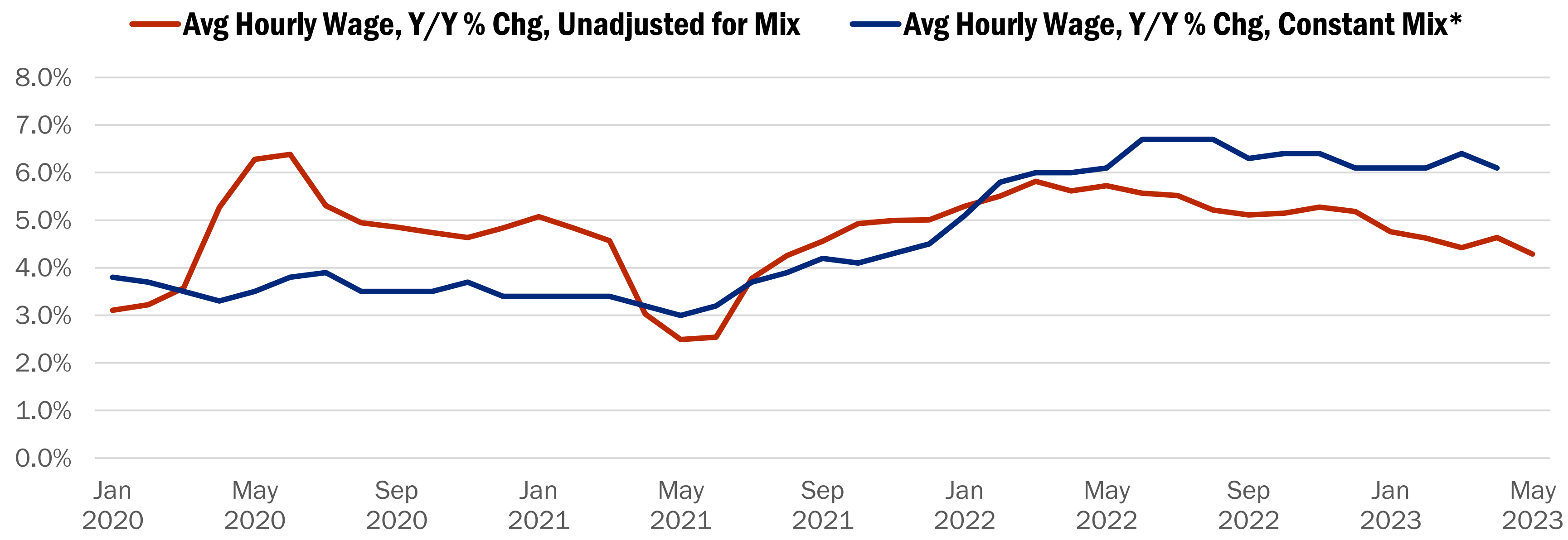
THE FASTEST GROWING SECTORS OF THE ECONOMY CONTINUE TO BE LOW-WAGE SECTORS SIGNIFICANTLY IMPACTED BY THE PANDEMIC.

	Job Growth Y/Y		Average Annual Wage Rate		Share of Total Employment	
Sector	US	VA	US	VA	US	VA
Leisure & Hospitality	5.4%	7.0%	$28,541	$24,869	10%	9%
Other Services	3.0%	3.5%	$46,122	$52,114	3%	3%
Education and Health	4.5%	3.0%	$58,119	$57,089	16%	13%
Information	0.3%	2.6%	$152,651	$129,516	2%	2%
Government	2.5%	2.1%	$65,170	$67,279	14%	18%
TOTAL	**2.6%**	**2.1%**	**$67,610**	**$67,990**	**100%**	**100%**
Construction	2.4%	1.6%	$69,855	$66,057	5%	5%
Professional & Business	2.4%	1.3%	$90,064	$100,319	15%	20%
Manufacturing	1.4%	0.9%	$76,580	$65,140	9%	6%
Finance	0.9%	0.5%	$115,238	$102,495	6%	5%
Retail, Wholesale, Trade	1.0%	0.0%	$55,728	$51,166	19%	17%

Sources: US BLS - Virginia data is through April while US data is through May

- Gains in the professional and business service sector, the largest and one of the highest paying sectors of the economy, have been moderate in both Virginia and the US. The underperformance in Virginia is particularly pronounced.

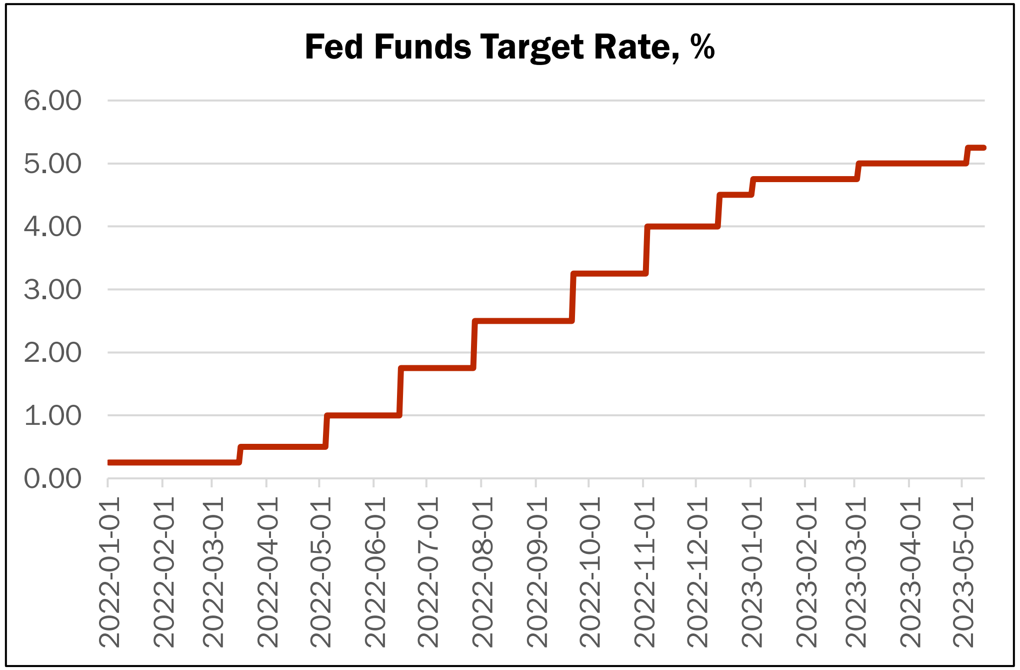
THE SLOWDOWN IN WAGE GAINS, AFTER ADJUSTING FOR INDUSTRY MIX, ARE MORE MODERATE THAN INDICATED BY THE UNADJUSTED NUMBER.

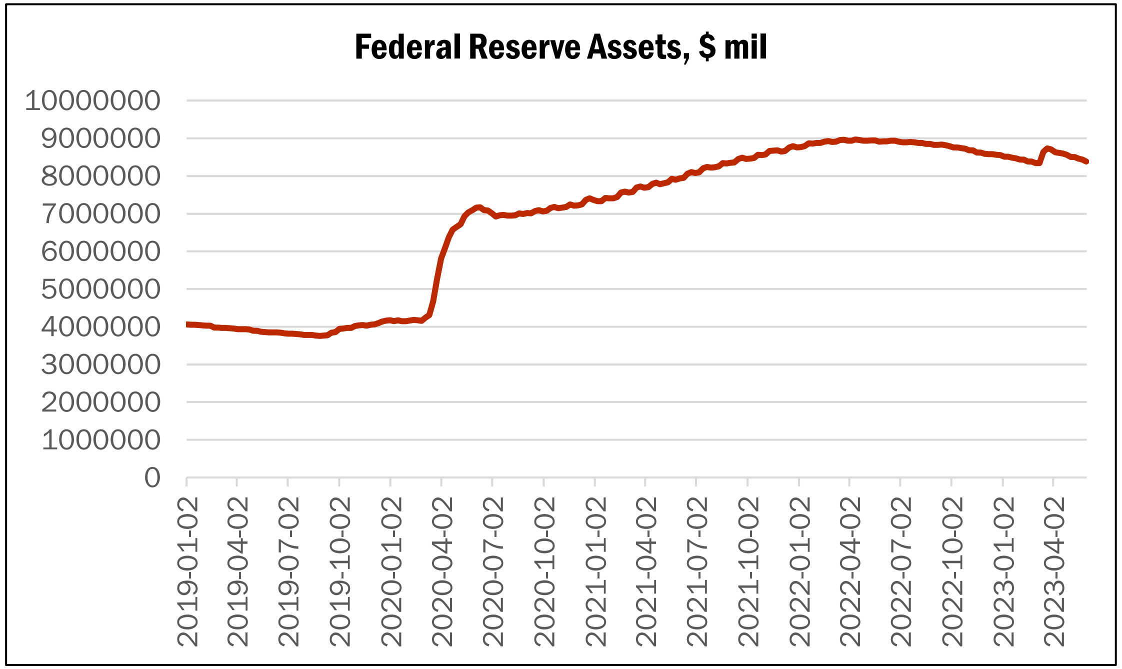


Sources: US BLS, Atlanta Federal Reserve Wage Tracker for Constant Mix

*The Atlanta Fed's Wage Growth Tracker is a measure of the nominal wage growth of individuals. It is constructed using microdata from the Current Population Survey (CPS), and is the median percent change in the hourly wage of the **same** individuals observed 12 months apart.

MOST ECONOMISTS EXPECT THE FED WILL REMAIN ON A HOLD PATTERN AT ITS JUNE 13TH MEETING.



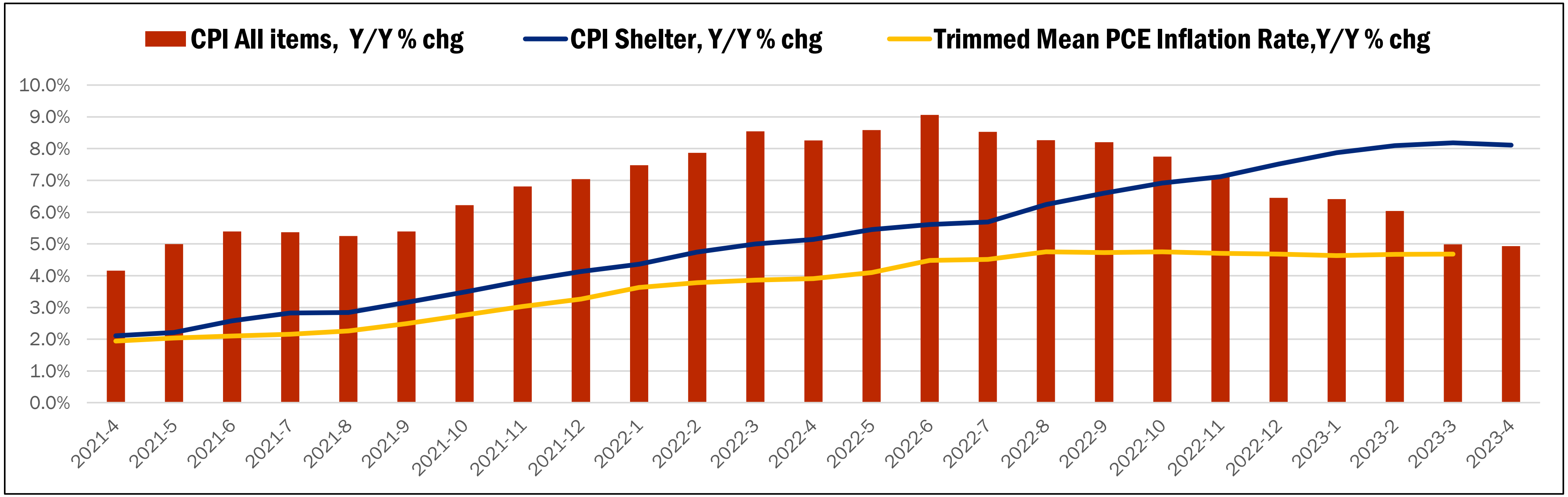


Source: Federal Reserve Board

- The Fed continues to unwind its balance sheet after the massive purchases that occurred during the pandemic and some purchases during the height of the recent banking crisis.

OVERALL INFLATION FELL BELOW 5 PERCENT IN APRIL FOR THE FIRST TIME IN OVER 2 YEARS CONTINUING THE DOWNWARD TREND SEEN SINCE MID-SUMMER. OTHER MEASURES OF INFLATION REMAIN ELEVATED.

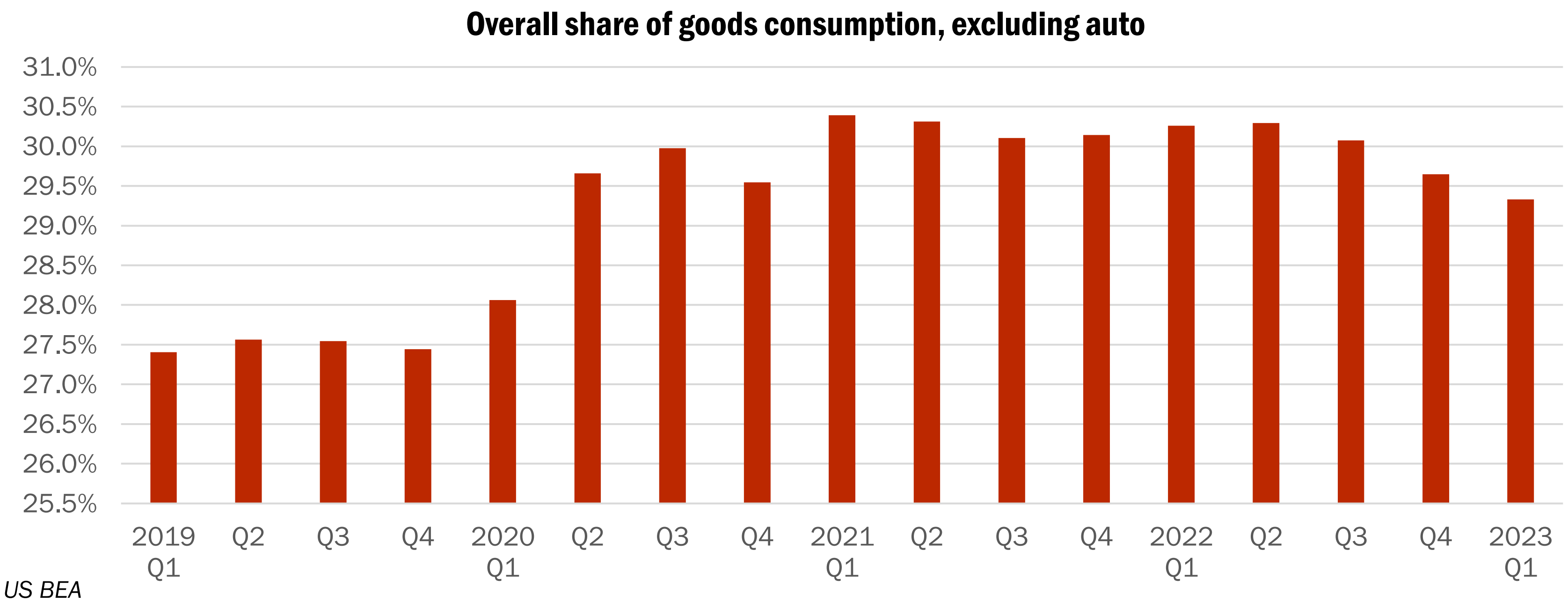
The Consensus for the upcoming release is that Overall CPI will decline further to 4.2% from 4.9%, driven by lower energy prices. Core drops to 5.2% from 5.5%



Sources: US BLS, Federal Reserve Bank of Dallas

- The shelter component of the CPI, which accounts for about one-third of the overall index, finally declined slightly in April
- The Trimmed Mean PCE inflation rate produced by the Federal Reserve Bank of Dallas is a proxy for true core PCE inflation rate that strips out the most volatile components. The resulting inflation measure has been shown to outperform the more conventional “excluding food and energy” measure as a gauge of core inflation.

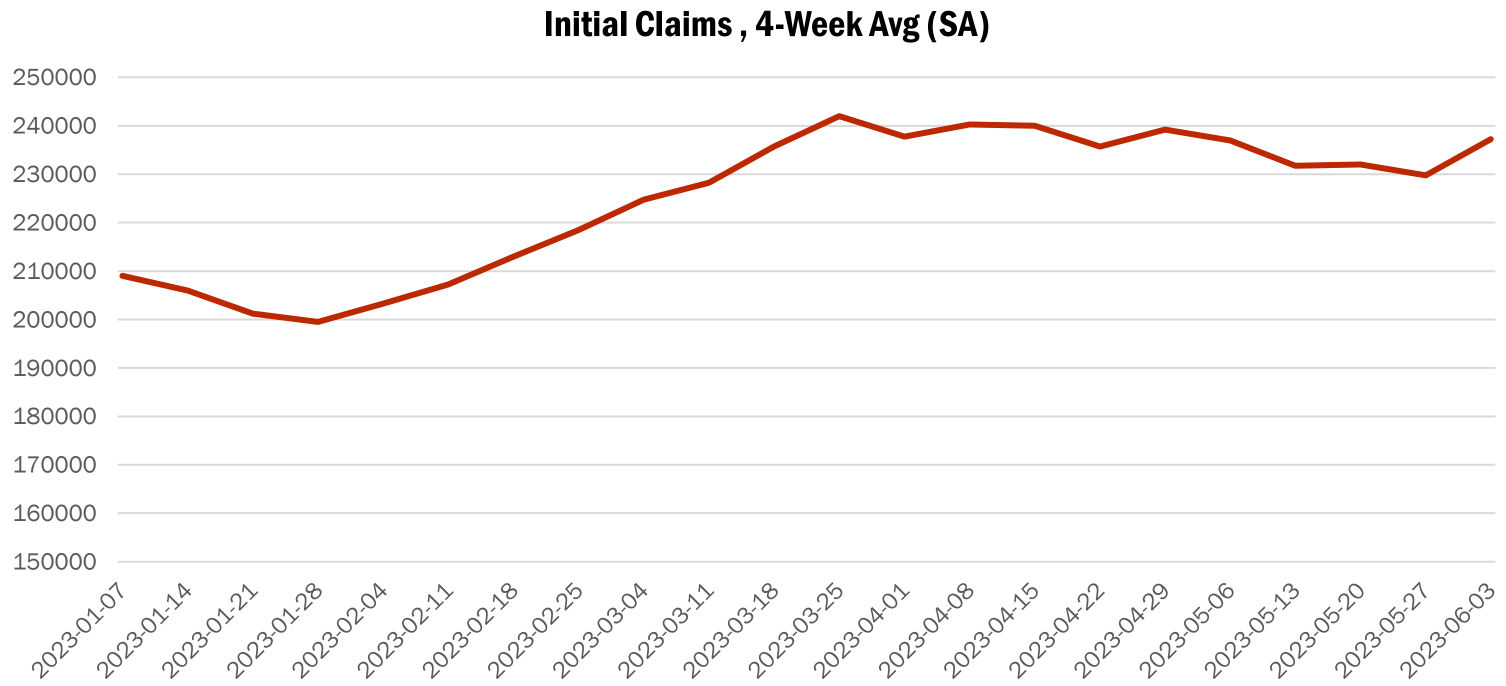
THE SHARE OF CONSUMPTION OF GOODS, WHICH SURGED DURING THE SHUTDOWN HAS TRENDED DOWNWARDS IN THE PAST FOUR QUARTERS.



Sources: US BEA

- The implications of the shift in consumption patterns is significant on sales tax revenue, as the base for sales tax revenue relies primarily on goods.

NOT ALL DATA SUGGESTS CONTINUED STRENGTH IN THE ECONOMY. CLAIMS FOR UNEMPLOYMENT INSURANCE HAVE TICKED UP DECISIVELY OVER THE PAST 3 MONTHS



Source :US BLS

- For the most recent week ending 6/3, UI claims spiked to 261,000. The number in chart is a 4-week average to adjust for weekly volatility

COLLECTION TRENDS: MAY AND FISCAL YEAR-TO-DATE SUMMARY

- Relative to the updated December forecast, unadjusted general fund revenues are ahead of forecast by $948 million year-to-date through May, driven by significantly higher than estimated collections for non-withholding. Revenues are $2.3 billion higher compared to Chapter 769. *(unless otherwise stated all comparisons hereafter will be made to the December forecast)*
- May revenues were impacted by the recently enacted PTET. The April 17 filing deadline for the PTET preceded the May 1 filing deadline for Individual Income tax, causing receipts to be shifted into April from May compared to prior years. For April and May combined, non-withholding revenues exceed projections by over $1 billion.
- Part of the unexpected strength in non-withholding is due to timing issues related to the posting of offsetting credits to individual income tax revenues that are associated with PTET payments. Many filers have still not filed final returns for this new tax.
- Using US non-withholding tax receipts, which declined by 38 percent versus 25 percent for Virginia, we estimate that the effect of these delays will lower revenues by in FY 2024 by about $600 million as returns are finalized and credits are posted.
- Offsetting some of the strength in non-withholding, withholding revenue was somewhat lower than expected by $41 million in May. Sales tax revenue continued to come in well below expectations, trailing projections by $67 million.

COLLECTION TRENDS: MAY AND FISCAL YEAR-TO-DATE SUMMARY

- Corporate tax revenue continued to surprise to the upside with a strong month in May. Fiscal year-to date revenues exceed projections by $112 million (6.7 percent).

- Strength in interest income has continued to offset weakness in deed recordation taxes.

- On an unadjusted basis versus prior year, total general fund revenues are down 3.4 percent fiscal year-to-date and down 21.3 percent for the month of May, due to the shift in filing deadlines related to the PTET.

MAY COLLECTIONS WERE $450.7 MILLION HIGHER THAN PROJECTED AND YEAR-TO-DATE COLLECTIONS ARE $948 MILLION AHEAD OF THE DECEMBER FORECAST, MAINLY DUE TO NON-WITHHOLDING.

Actuals Versus December Forecast

	MAY					FYTD				
SOURCE $000s	Actuals	Projected	Variance	Prior Year	Y/Y %	Actuals	Projected	Variance	Prior Year	Y/Y%
Withholding	1,260,897	1,301,973	(41,076)	1,223,289	3.1%	14,588,118	14,700,470	(112,351)	14,007,150	4.1%
Non-withholding	766,633	308,379	458,254	1,465,173	-47.7%	6,019,503	4,959,058	1,060,445	6,188,147	-2.7%
IIT Refunds	(193,091)	(233,499)	40,408	(138,174)	39.7%	(3,417,446)	(3,333,709)	(83,737)	(1,656,157)	106.3%
Net IIT	1,834,439	1,376,852	457,587	2,550,288	-28.1%	17,190,175	16,325,819	864,356	18,539,140	-7.3%
Sales/Use	380,456	449,358	(68,902)	402,422	-5.5%	4,326,919	4,512,763	(185,844)	4,082,747	6.0%
Corporate	58,498	49,879	8,619	52,248	12.0%	1,681,612	1,569,158	112,454	1,658,495	1.4%
Wills	38,775	48,004	(9,229)	58,225	-33.4%	389,309	463,137	(73,828)	600,358	-35.2%
Insurance	16,188	10,289	5,899	28,178	-42.6%	309,000	294,739	14,261	296,749	4.1%
All Other	200,321	143,635	56,686	107,949	85.6%	1,107,024	890,378	216,646	710,082	55.9%
Total GF Revenues	2,528,677	2,078,016	450,660	3,199,310	-21.0%	25,004,038	24,055,994	948,043	25,887,571	-3.4%

- Non-withholding revenue declined by far less than anticipated in the forecast. Year-to date through May, collections for this source exceed the full year forecast although timing issues related to the PTET impacted results. See slides 16-18 for further detail.

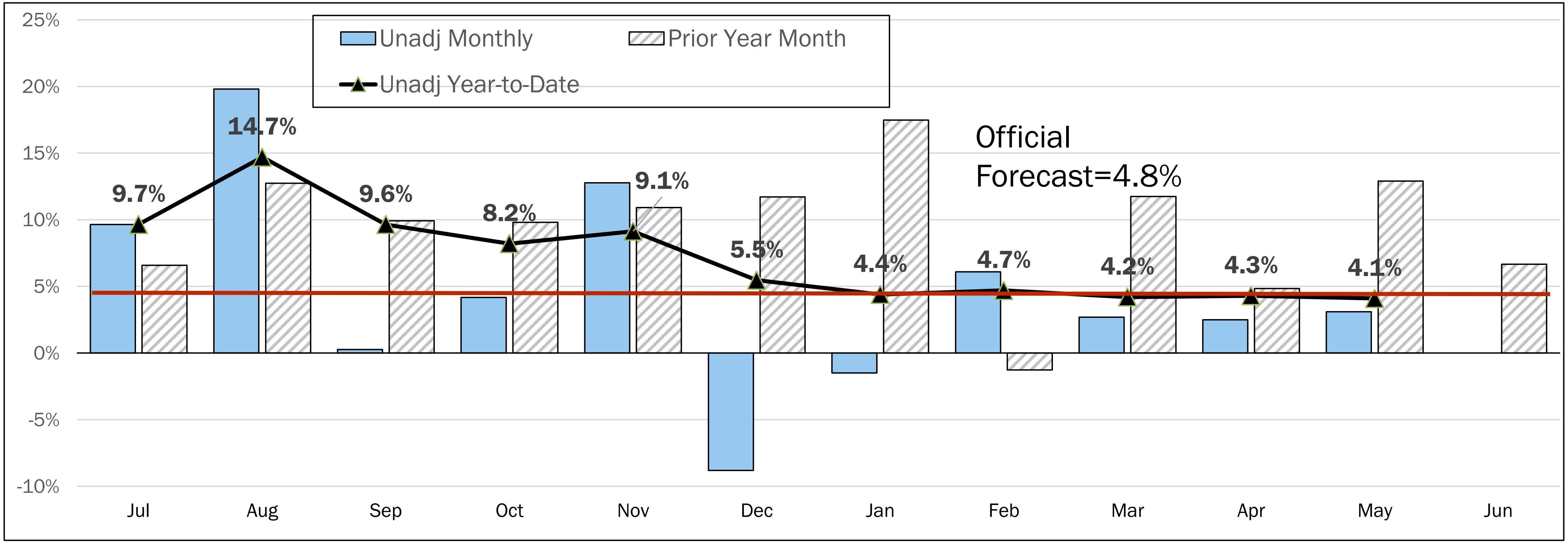
FISCAL YEAR-TO-DATE, REVENUES ARE SIGNIFICANTLY HIGHER THAN THE DECEMBER ESTIMATE. ON AN UNADJUSTED BASIS, GF REVENUES WERE SHARPLY LOWER IN MAY, DUE PARTLY TO THE SHIFTING FILING DEADLINE RELATED TO THE PTET.

	FY 2023	Pct Chg	Percent of	MAY				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%	1,223.3	1,260.9	37.6	3.1%	14,007.2	14,588.1	581.0	4.1%	58.3%
Nonwithholding	5,088.6	-25.3%	19.3%	1,465.2	766.6	(698.5)	-47.7%	6,188.1	6,019.5	(168.6)	-2.7%	24.1%
Refunds	(3,535.2)	103.1%	-13.4%	(138.2)	(193.1)	(54.9)	39.7%	(1,656.2)	(3,417.4)	(1,761.3)	106.3%	-13.7%
Sales and Use Tax	4,926.3	8.1%	18.7%	402.4	380.5	(22.0)	-5.5%	4,082.7	4,326.9	244.2	6.0%	17.3%
Corporate Income Tax	1,809.1	-8.6%	6.9%	52.2	58.5	6.3	12.0%	1,658.5	1,681.6	23.1	1.4%	6.7%
All Other Sources	2,020.7	1.7%	7.7%	194.4	255.3	60.9	31.4%	1,607.2	1,805.3	198.1	12.3%	7.2%
Total GF Revenues	**$26,387.8**	**-8.8%**	**100.0%**	**$3,199.3**	**$2,528.7**	**($670.6)**	**-21.0%**	**$25,887.6**	**$25,004.0**	**($883.5)**	**-3.4%**	**100.0%**

Adjusted Revenues								
Adjusted Withholding	1,223.3	1,328.9	105.6	8.6%	14,007.2	14,945.7	938.5	6.7%
Adjusted Non-Withholding (PTET)	1,465.2	711.6	(753.5)	-51.4%	6,188.1	5,496.5	(691.6)	-11.2%
Adjusted Refunds+Rebates	(138.2)	(104.0)	34.2	-24.7%	(1,656.2)	(2,089.2)	(433.0)	26.1%
Adjusted Sales (AST+ Grocery Tax)	402.4	399.6	(2.8)	-0.7%	4,286.1	4,419.3	133.1	3.1%
Total GF Revenues, Adjusted	**$3,199.3**	**$2,630.7**	**($568.6)**	**-17.8%**	**$26,091.0**	**$26,038.7**	**($52.2)**	**-0.2%**

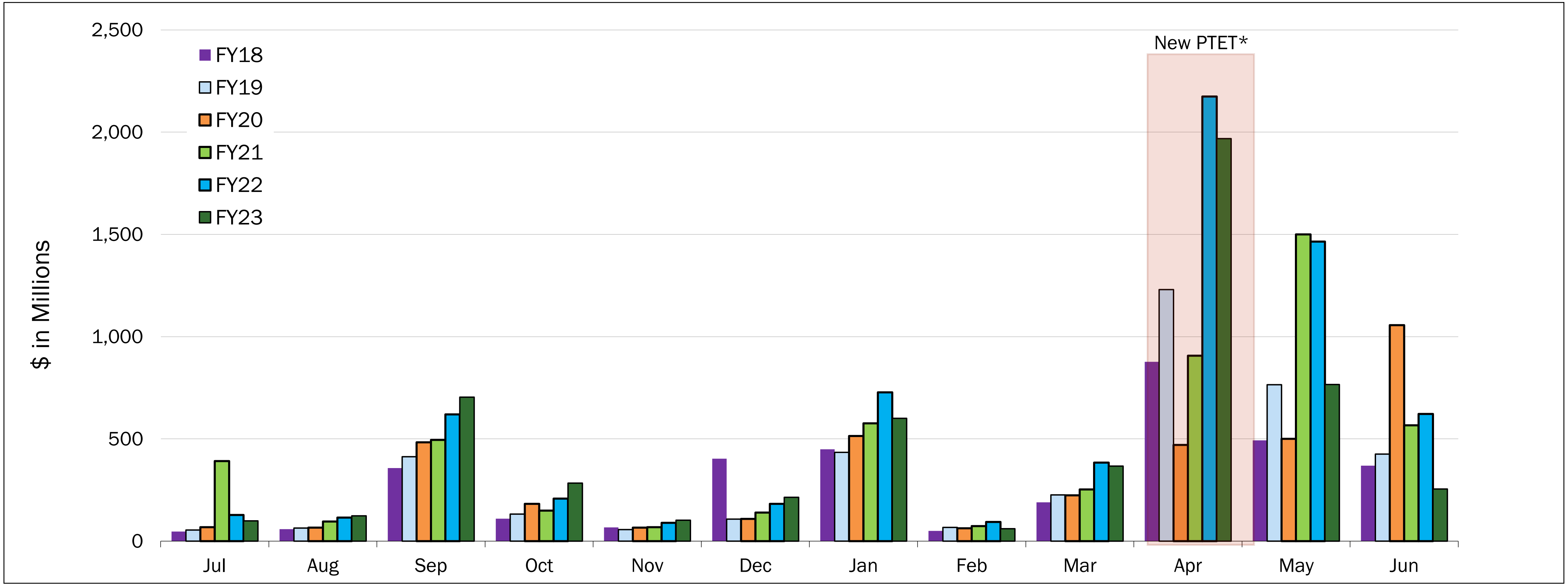
- On an adjusted basis, reflecting the numerous tax reductions that were enacted--one-time tax rebates, the increased standard deduction, the expanded EITC, the military retirement subtraction, and the elimination of the State grocery tax--overall revenues are essentially flat fiscal year- to-date.

WITHHOLDING IS SLOWING AT A SLIGHTLY FASTER PACE THAN PREDICTED. FISCAL YEAR-TO-DATE COLLECTIONS ARE $112 MILLION OR 0.8 PERCENT BELOW ESTIMATE.



- On an adjusted basis to account for the increased standard deduction, withholding year-over-year growth is estimated at 6.9 percent.
- Compared to the December forecast employment is running ahead of plan but the overall wage rate has been dragged down more than expected due to the higher mix of low-paying jobs.

NON-WITHHOLDING TAX COLLECTIONS DECLINED IN MAY BY ALMOST 50 PERCENT COMPARED TO THE PREVIOUS YEAR BUT TIMING ISSUES IMPACTED APRIL AND MAY RESULTS.



- PTET shifted about $413 million (1/2 of $826 million received in April) of income that would have otherwise been received in May.

NON-WITHHOLDING COLLECTIONS IN APRIL-MAY ARE ABOUT 25 PERCENT LOWER THAN IN 2022.

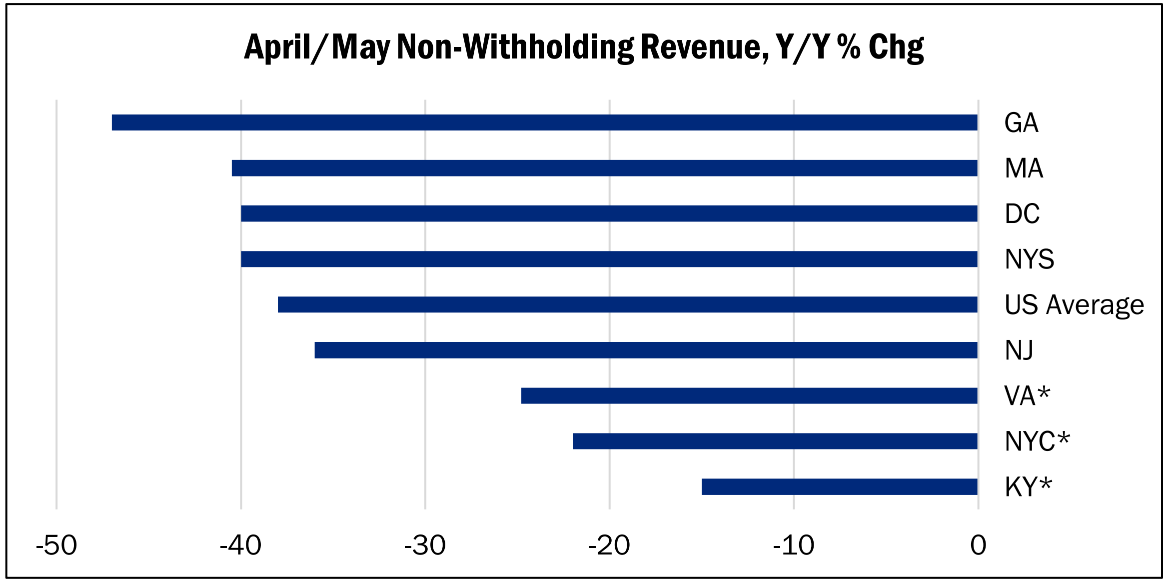
Virginia non-withholding collections April and May, 000s

	FY 2023,	FY 2022	Y/Y % chg
April	1,968,482	2,173,908	-9.4%
May	766,633	1,465,173	-47.7%
Total	**2,735,115**	**3,639,081**	**-24.8%**

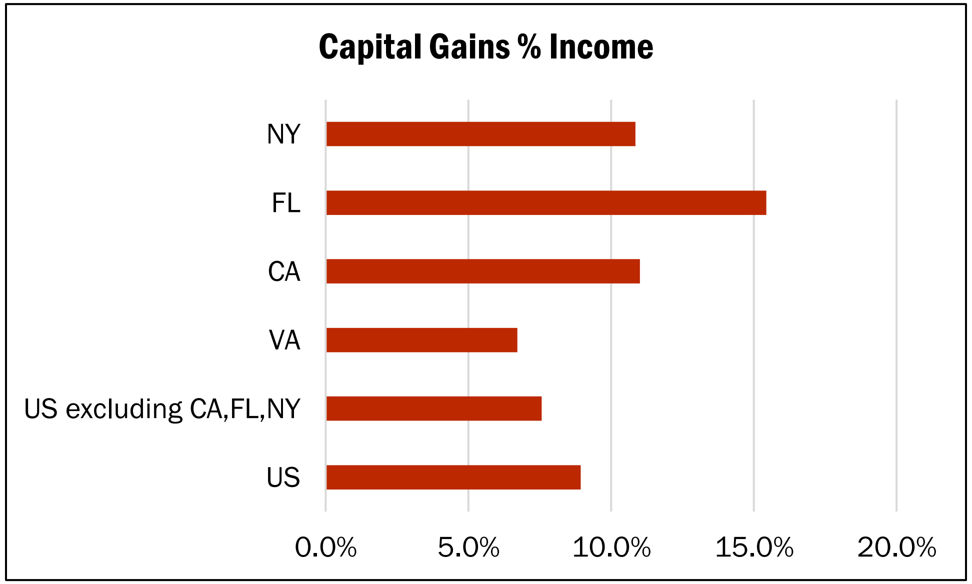
- The PTET, which has a filing deadline of April 15th, caused a significant shift in collections to occur from May to April.
- In the December forecast April-May non-withholding collections were forecast to decrease by 35 percent.
- Virginia should typically behave like the US given its similar exposure to capital gains.

DECLINES IN NON-WITHHOLDING WERE CORRELATED TO PTET ADOPTION.

States that enacted PTET in the past year saw above-par performances. Early adopters of PTET saw credits catch up and experienced steep declines in revenues in April and May.



Source: FTA, State websites



Source: US IRS

*Denotes States that adopted PTET only in the past year in contrast to other States that adopted PTET earlier or have not adopted a PTET.

Virginia's exposure to capital gains is similar to the US. Assuming the difference in performance is related to the PTET timing issue, non-withholding would have been about $600 million lower.

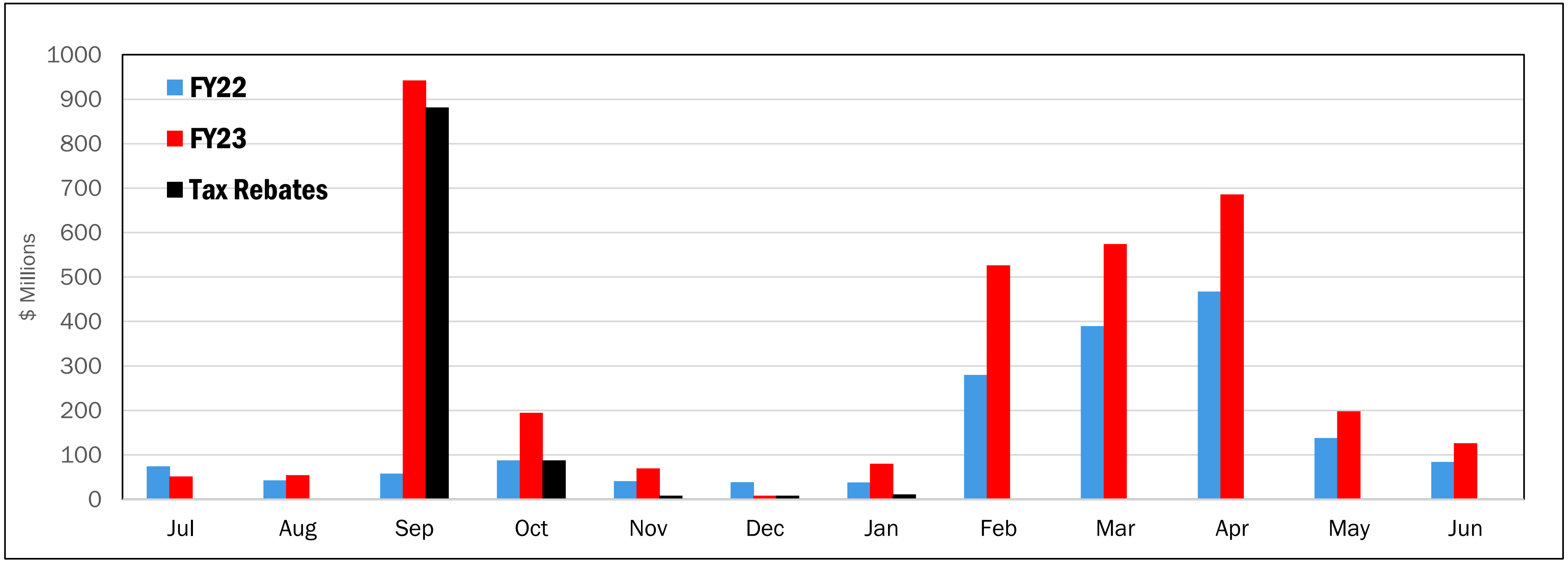
CAUTION ON PTET AND NON-WITHHOLDING RESULTS: EARLY ADOPTERS SAW CREDITS CATCH UP AND HAD STEEPER THAN EXPECTED DECLINES.

“States that adopted pass-through entity (PTE) taxes (aka SALT workarounds) prior to 2022 experienced a bigger drop in April/May 2023 individual income tax collections than states that only adopted PTE taxes last year or this year”
Federal Tax Administrators- Listserv

“New Jersey was not alone in experiencing these April declines. Connecticut, New York, Pennsylvania, Massachusetts, and even the federal government have also reported declines, some significantly lower than forecast. For example, Massachusetts missed its April target by over $1 billion and Connecticut by over $500 million, on a much smaller revenue base. The federal income tax collections weakness has reportedly hastened the arrival of the debt ceiling deadline.”

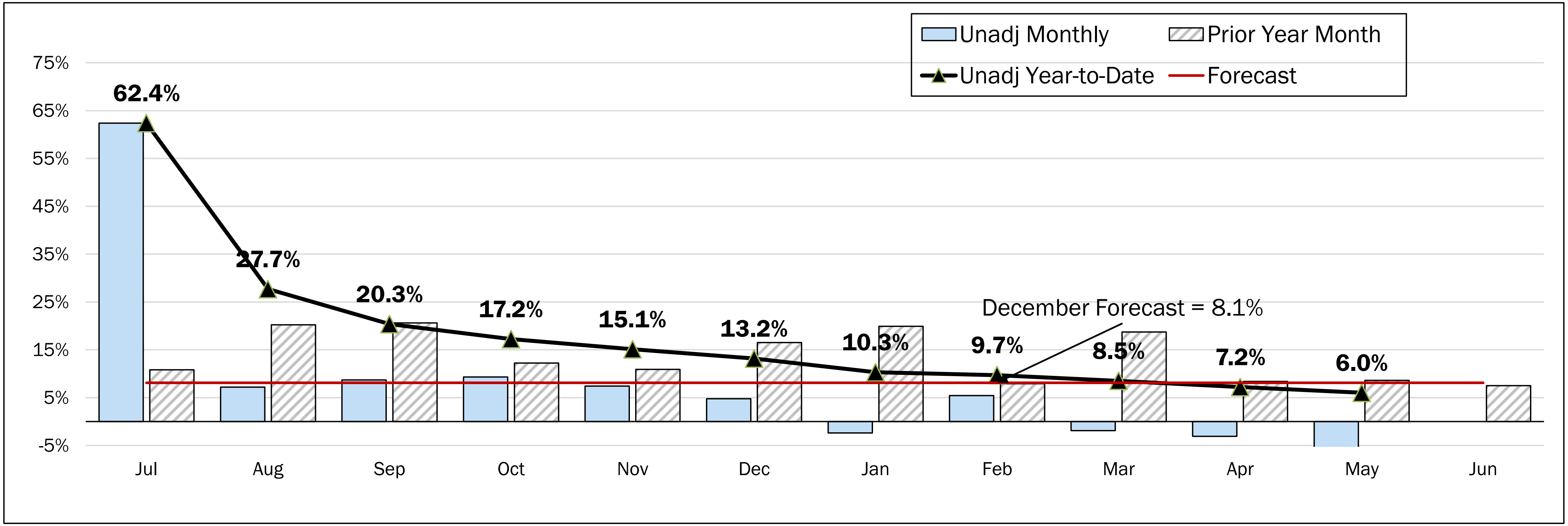
“Still, the major cause of April's downward surprise this year lies in Tax Year 2022, and the significant decline in net gains. When the tax return processing, including extensions, is completed later this year, 2022 is likely to have witnessed the largest decline of net gains in a non-recessionary year. Perhaps the largest decline for any year.”
NJ State Treasurer Elizabeth Maher Muoio, Testimony as Prepared for Delivery, May 17, 2023

REFUNDS IN MAY TOTALED ALMOST $193 MILLION. FISCAL YEAR-TO-DATE REFUNDS EXCEED PROJECTIONS BY $84 MILLION.



- The increase in refunds is due in part to policy actions including, one-time rebates, the increased standard deduction, the expanded EITC, and the military retirement subtraction.
- Refunds are also expected to increase as PTET filers claim credits against income taxes paid. This will spill over into FY 2024.

UNADJUSTED SALES TAX COLLECTIONS DECLINED BY 5.5 PERCENT IN MAY, THE THIRD CONSECUTIVE MONTHLY DECLINE.



- Adjusting for the elimination of the state grocery tax, sales tax revenue declined by 1.0 percent year-over-year.
- 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 elimination in June. This is expected to further lower collections in June by $72 million or about 1.1%.

OTHER SOURCES:

- Corporate income tax revenues showed surprising strength in April and May, reversing the weakness seen in the beginning of the year and are on pace to equal or exceed forecast.
- Deed recordation taxes have been consistently weaker than expected as interest rates have remained high and sharply curtailed refinancing activity. Fiscal year-to-date revenues from this source are almost $68 million lower than projected.
- Other Revenues exceed forecast by almost $216 million fiscal year-to-date.

COLLECTIONS SUMMARY AND KEY UPCOMING DATES

- Non-withholding revenues for the current filing season, while declining, have come in significantly higher than expected. Both the timing and the composition of revenues has shifted due to the new PTET tax that allows filers to circumvent the SALT limitation.
- Because this is the first year of implementation for this tax, the final liability will only be known in FY 2024. Given the performance of other states that adopted PTET earlier and the overall non-withholding collections results for the Federal government, the impact in FY 2024 is expected to be around $600 million.
- Within other major sources, sales tax collections and deed recordation taxes are significantly trailing estimates. Withholding is also behind forecast, but by a smaller amount.
- However, weaknesses in these sources are more than offset by other sources. In addition to non-withholding, interest income and corporate income taxes are exceeding forecast.
- June collections will include the second installment for individual estimated payments, which could be lower as result of the PTET and large payments made in April and May. Sales tax collections are likely to decline further continuing to offset some of the surplus.

APPENDIX

MAY COLLECTIONS CAME IN $530 MILLION HIGHER THAN PROJECTED AND YEAR-TO-DATE COLLECTIONS ARE $2.3 BILLION AHEAD OF THE CHAPTER 769 FORECAST.

Actuals Versus Chapter 769 Forecast

	MAY					FYTD				
SOURCE $000s	Actuals	Projected	Variance	Prior Year	Y/Y %	Actuals	Projected	Variance	Prior Year	Y/Y%
Withholding	1,260,897	1,343,449	(82,552)	1,223,289	3.1%	14,588,118	14,113,023	475,095	14,007,150	4.1%
Non-withholding	766,633	276,153	490,480	1,465,173	-47.7%	6,019,503	5,035,819	983,684	6,188,147	-2.7%
IIT Refunds	(193,091)	(251,049)	57,958	(138,174)	39.7%	(3,417,446)	(3,664,902)	247,456	(1,656,156)	106.3%
Net IIT	1,834,439	1,368,554	465,885	2,550,288	-28.1%	17,190,175	15,483,940	1,706,235	18,539,141	-7.3%
Sales/Use	380,456	397,742	(17,286)	402,423	-5.5%	4,326,919	4,169,103	157,816	4,082,748	6.0%
Corporate	58,498	47,891	10,607	52,248	12.0%	1,681,612	1,458,613	222,999	1,658,495	1.4%
Wills	38,775	55,447	(16,672)	58,225	-33.4%	389,309	534,951	(145,642)	600,358	-35.2%
Insurance	16,188	9,831	6,357	28,178	-42.6%	309,000	282,299	26,701	296,749	4.1%
All Other	200,321	119,084	81,237	107,949	85.6%	1,107,024	745,398	361,626	710,079	55.9%
Total GF Revenues	2,528,677	1,998,548	530,128	3,199,311	-21.0%	25,004,039	22,674,305	2,329,734	25,887,570	-3.4%