ECONOMIC AND REVENUE REVIEW AND UPDATE

A BRIEFING FOR THE MONEY COMMITTEES

Stephen E. Cummings
Secretary of Finance
Commonwealth of Virginia
www.finance.virginia.gov
February 2024

TOPICS FOR DISCUSSION

ECONOMIC UPDATE

JANUARY FISCAL YEAR-TO-DATE REVENUE COLLECTIONS

MID-SESSION FORECAST REVIEW

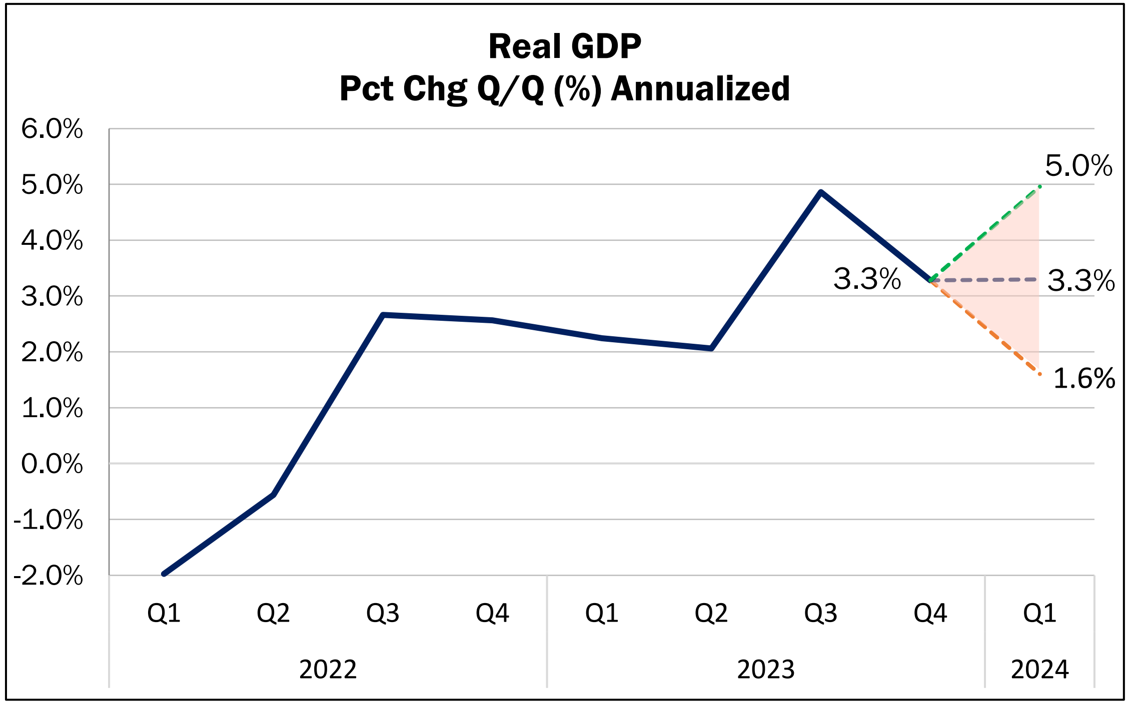
SUMMARY

- For the month of January, general fund revenue collections fell by 2.5 percent, driven by lower individual nonwithholding collections.
- Individual income tax nonwithholding collections for the month declined by an unexpected 27.5 percent year-over-year as taxpayers adjusted for lower pass-through income and the timing of the new PTET.
- For fiscal year-to-date through January 31, unadjusted general fund revenues increased 5.3 percent against the same period last year. Net individual income tax collections (+5.0 percent), corporate income tax (+11.7 percent) and interest income (+123.9 percent) are all higher compared to last year, while sales and use tax collections (-1.6 percent), insurance premiums (-8.3 percent), and wills, suits and deeds (-14.4 percent) are lower year-to-date.
- While year-to-date nonwithholding revenues are in line with the forecast assumed in HB/SB 29, the significant decrease in January estimated payments cautions that collections in the fourth quarter, when the majority of receipts in this source are received, may decline more than anticipated.
- Compared to the forecast assumed in the Governor’s proposed budget, year-to-date revenues are ahead of projections by $704.1 million. Excluding nonwithholding and refunds, which continue to be distorted by PTET, year-to-date collections are ahead of plan by $419.8 million, a variance of 3.0 percent.
- Withholding collections exceeded projections for the month of January by $242.2 million (18.2 percent) contributing to year-to-date results being ahead by $401.4 million (4.4 percent). The timing of receipts from a limited number of unique taxpayers accounted for approximately one-third of excess withholding collections in January.

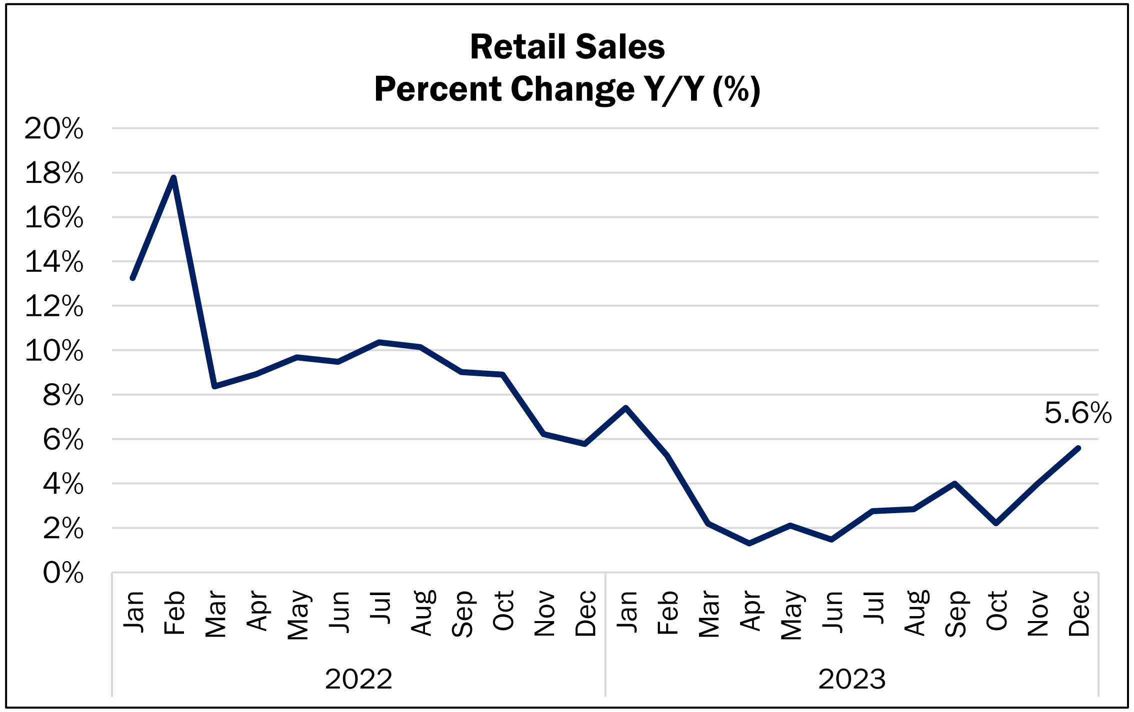
SUMMARY (CONT'D)

- Recent economic data are mixed. U.S. Real GDP grew 3.3 percent in the fourth quarter driven by consumer spending, and December retail sales grew 5.6 percent year-over-year in December. However, increasing consumer delinquencies suggest consumer spending will weaken in coming months.
- Virginia employment fell by 11,800 jobs in December, the first decline in 14 months despite the more than 330,000 jobs added nationally during the same period, and the Virginia unemployment rate ticked up for the third straight month.
- The strong U.S. jobs report and continued elevated inflation create uncertainty around future Fed rate actions.
- While some economists have turned more positive in recent months, there continues to be conflicting data on current state of economy and the existence of ongoing macroeconomic risks and uncertainties that support our prudent outlook for a mild economic contraction in calendar year 2024, including:
    - The lagged effects of restrictive monetary policy which will impact corporate profits, slow hiring, further curtail housing market activity, and reduce consumer spending.
    - The spend down of pandemic savings and deteriorating consumer balance sheets that will impact consumer spending and dampen economic growth further.
    - The continued potential for a federal government shutdown if lawmakers are unable to reach agreement on a budget by early March.
    - Escalating conflict in the Middle East that could drive significantly higher energy prices.
    - The real estate crisis in China and the resulting impact on financial markets which could have ripple effects throughout the broader global economy.

FOURTH QUARTER ECONOMIC GROWTH REMAINED STRONG, LED BY CONSUMER SPENDING



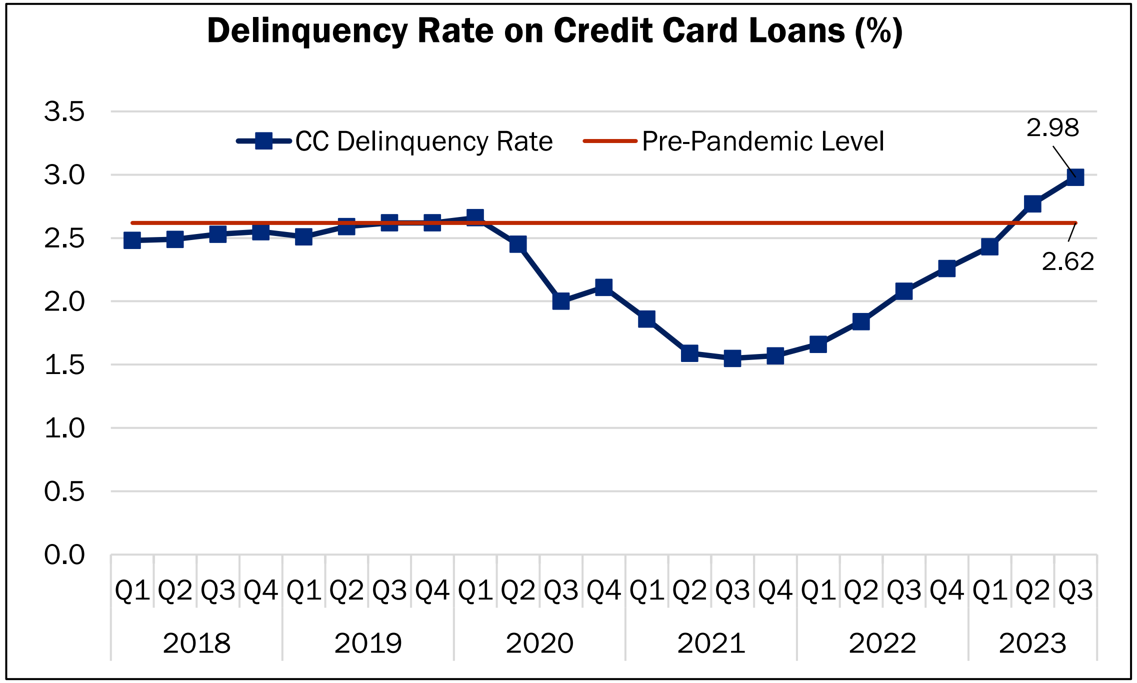
Source: U.S. Bureau of Labor Statistics; New York Fed Staff Nowcast



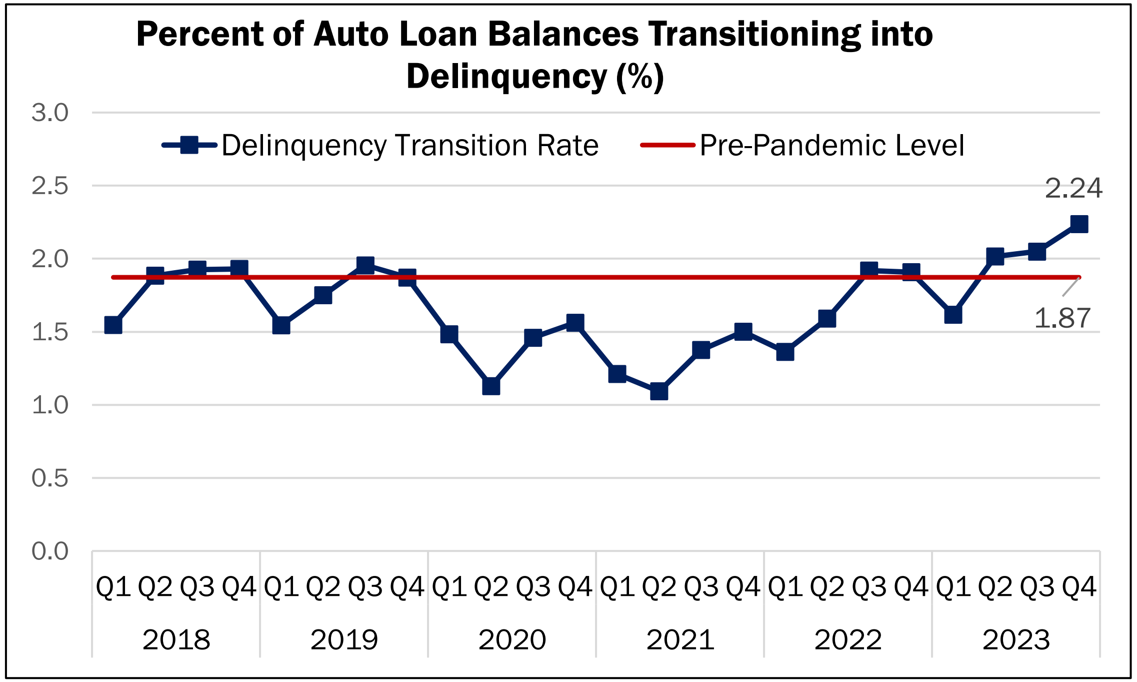
Source: U.S. Census Bureau.

- Real GDP grew 3.3 percent in Q4 of 2023, according to the advance estimate released by BLS. The increase in real GDP reflected increases in consumer spending, exports, state and local government spending, nonresidential fixed investment, federal government spending, private inventory investment, and residential fixed investment.
- December 2023 U.S. retail sales increased 0.6 percent from the previous month and a 5.6 percent increase year-over-year.

INCREASING DELINQUENCIES INDICATE GROWING CONSUMER STRESS



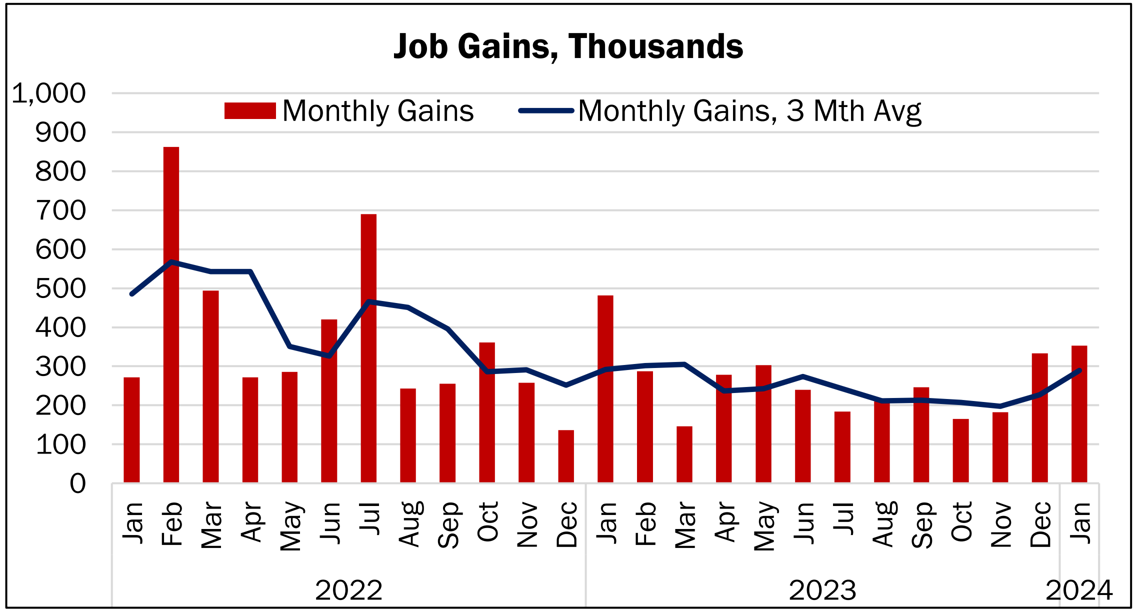
Source: Federal Reserve Bank of St. Louis.



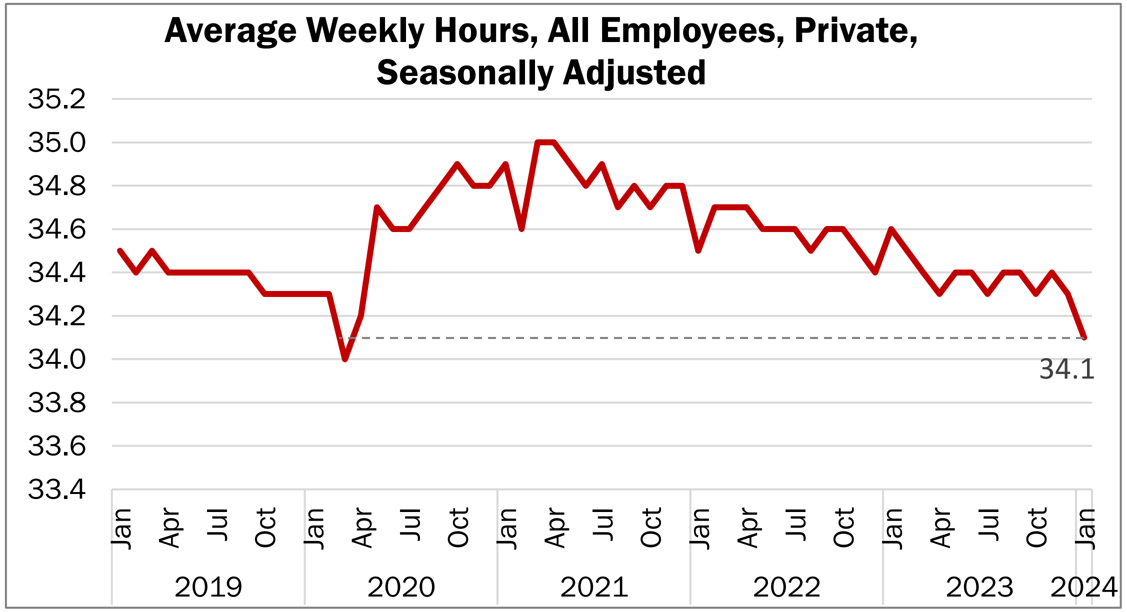
Source: New York Fed Consumer Credit Panel/Equifax, using Philadelphia Fed auto loan tradeline data. Note: The chart shows transition rates into 30-day delinquency and rates are balance-weighted.

- Household debt reached $17.5 trillion in the fourth quarter of 2023, and delinquency rates rose for all debt types except student loans (NY Fed).
- Both credit card delinquencies and auto loan delinquencies have ticked up above pre-pandemic levels, indicating a spend down of the cash reserves households accumulated during Covid and suggesting consumer spending may soften in coming months.

U.S. PAYROLL EMPLOYMENT SURPRISED IN JANUARY WHILE AVERAGE HOURS WORKED FELL TO PANDEMIC LEVELS



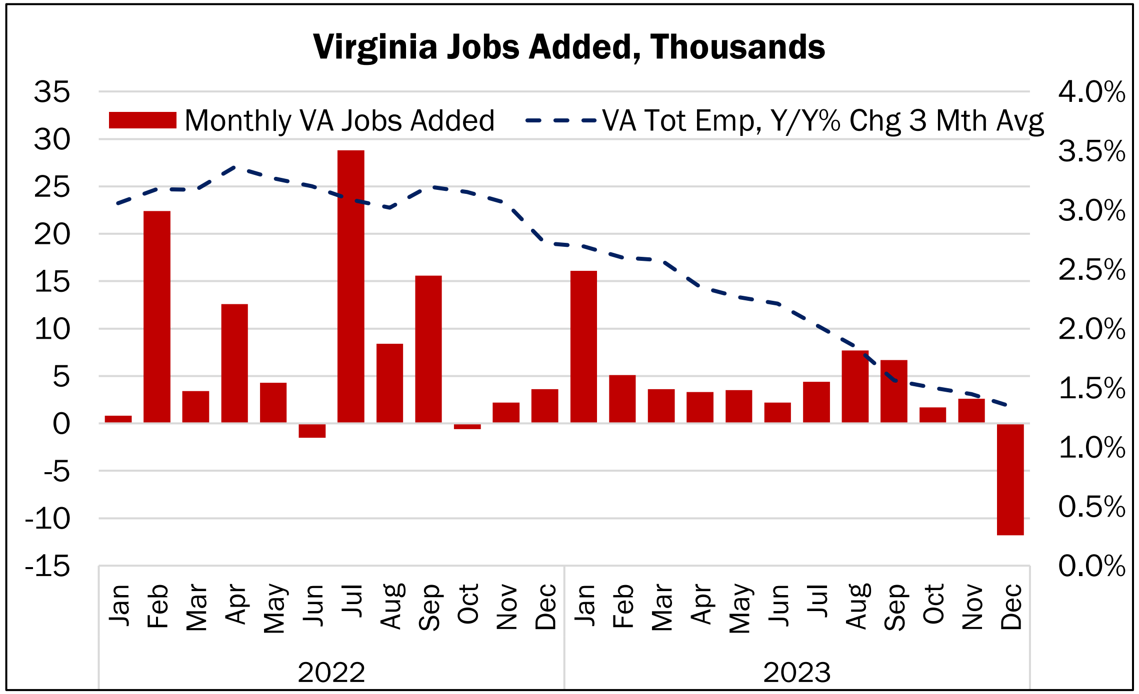
Source: US Bureau of Labor Statistics.



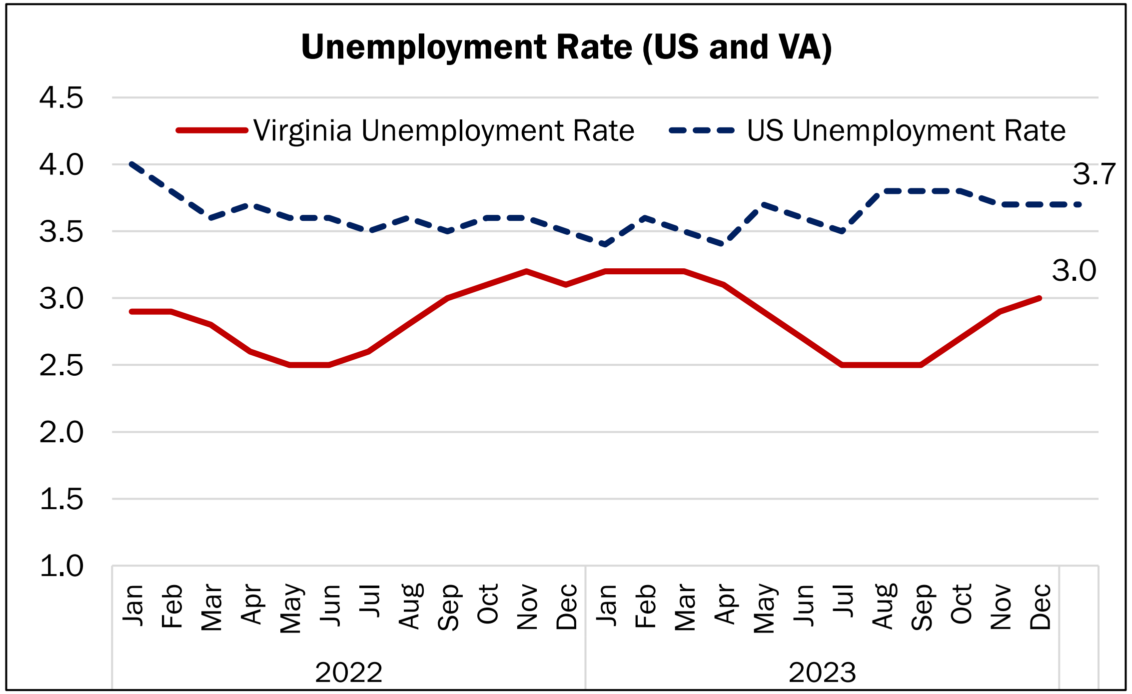
Source: Federal Reserve Bank of St. Louis; US Bureau of Labor Statistics.

- U.S. nonfarm payrolls increased 353,000 in January, following the gain of 333,000 (revised) in December.
- Payroll employment increased by an average of 255,000 per month in 2023.
- Despite the gain in total payrolls in January, there is a concerning downward trend in average hours worked. Workers in the private sector worked an average of 34.1 hours per week in January 2024, the lowest since March 2020, with the onset of COVID.

VIRGINIA EMPLOYMENT FELL IN DECEMBER AS THE STATE UNEMPLOYMENT RATE TICKED UP FOR THE THIRD STRAIGHT MONTH



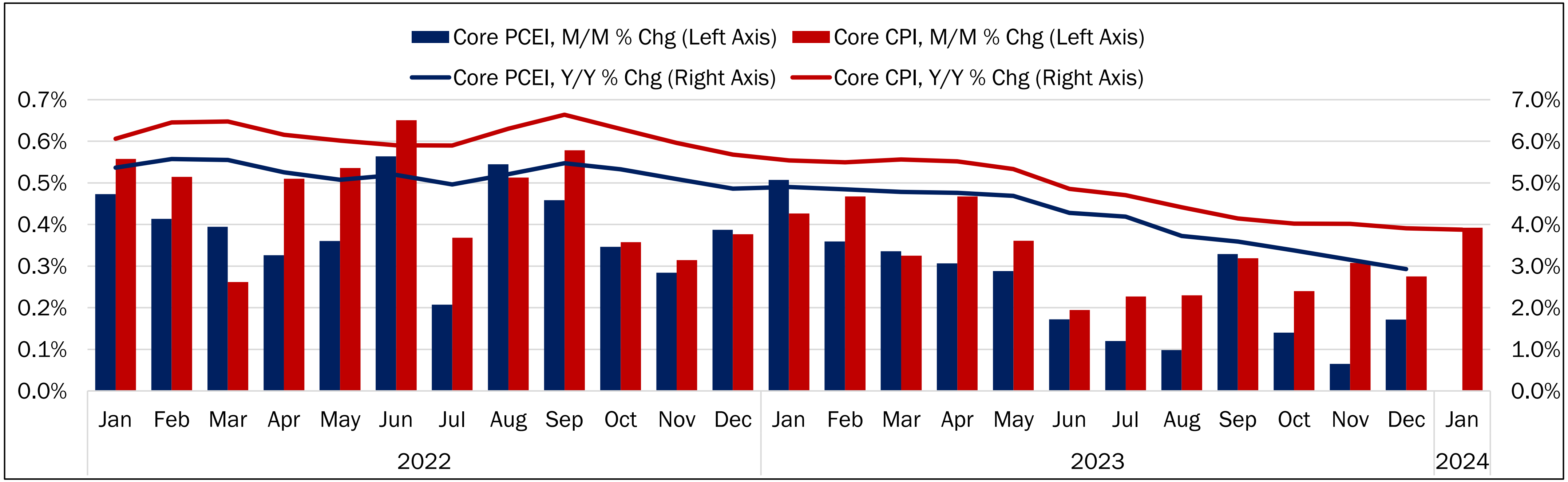
Source: US Bureau of Labor Statistics.



Source: US Bureau of Labor Statistics.

- In December, Virginia's nonagricultural employment, from the monthly establishment survey decreased by 11,800 to 4.16 million. The private sector employment decreased by 5,600 while government employment decreased by 6,200.
- Three-month average year-over-year growth in Virginia employment continued to slow, measuring 1.3 percent in December.
- Virginia's seasonally adjusted unemployment rate in December increased by 0.1 percentage points to 3.0 percent.

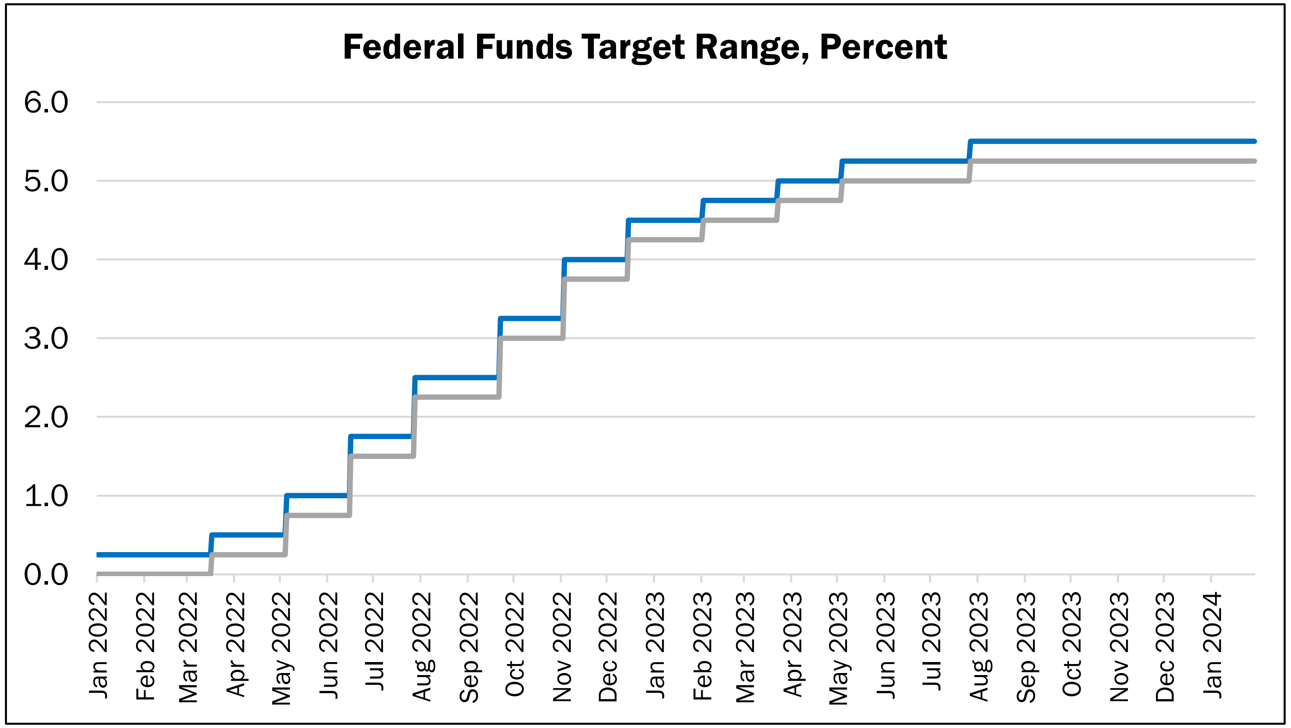
CORE INFLATION MEASURES REMAIN ELEVATED



Source: U.S. Bureau of Economic Analysis; U.S. Bureau of Labor Statistics.

- In January, the Consumer Price Index for All Urban Consumers increased 0.3 percent, up 3.1 percent year over year. Core CPI, which excludes food and energy, increased 0.4 percent in January. Core CPI is up 3.9 percent over the year, the same as in December.
- The twelve-month change in Core Personal Consumption Expenditure Price Index (Core PCE), the Federal Reserve's preferred inflation measure, declined to 2.9 percent in December, though it is still well above the Fed's two-percent target.

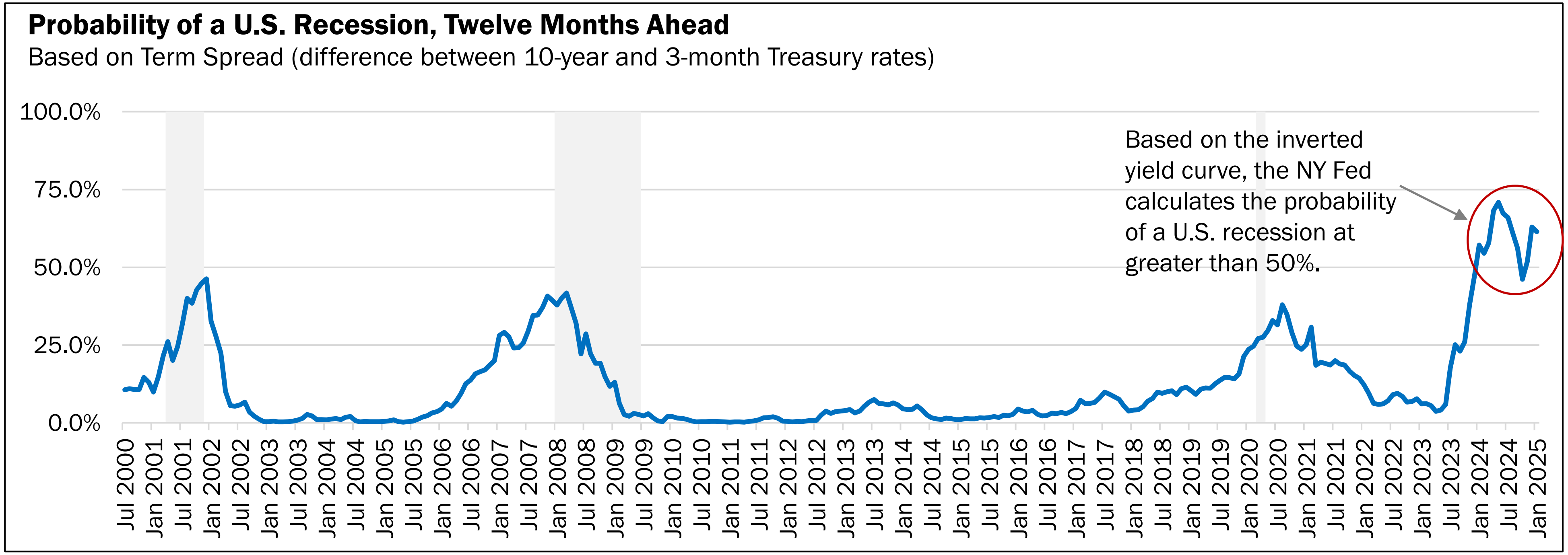
THE FED HELD RATES STEADY IN JANUARY, TIMING OF FURTHER ACTIONS UNCERTAIN



Source: Federal Reserve of St. Louis.

- The Fed announced on January 31, 2024, that it would maintain its policy rate in a range of 5.25 percent to 5.5 percent
- This was the fourth straight meeting at which the Fed has held interest rates steady.
- Chair Powell was quoted as saying that the "policy rate is likely at its peak for this tightening cycle…".
- However, he indicated that policymakers are "highly attentive" to inflationary risks and suggested rates may remain at current levels through the end of CY 2024 if necessary.

A U.S. RECESSION IN THE NEXT TWELVE MONTHS REMAINS A POSSIBILITY



Gray bars indicate recessions.

Source: Federal Reserve Bank of New York, The Yield Curve as a Leading Indicator, https://www.newyorkfed.org/research/capital_markets/ycfaq.html

- The yield curve inverted in late 2022 and has remained inverted, signaling the likelihood of a U.S. recession. (An inverted yield curve means longer-term bond yields are below those of short-term bonds.)
- According to research by the Federal Reserve Bank of New York, yield curve inversion has historically predicted U.S. recessions with greater accuracy than many other economic indicators.

FISCAL YEAR-TO-DATE COLLECTIONS ARE 4.6 PERCENT ABOVE THE DECEMBER FORECAST

	Unadjusted Revenues							
	January				FYTD			
SOURCE, $ Mil	Actuals	Projected	Variance $	Variance %	Actuals	Projected	Variance $	Variance %
Withholding	$1,570.5	$1,328.3	$242.2	18.2%	$9,565.5	$9,164.1	$401.4	4.4%
Non-withholding	656.9	793.8	(136.9)	-17.2%	2,689.6	2,471.3	218.3	8.8%
IIT Refunds	(66.2)	(209.9)	143.7	-68.4%	(1,191.3)	(1,257.2)	65.9	-5.2%
Net Individual Income	$2,161.2	$1,912.1	$249.0	13.0%	$11,063.8	$10,378.2	$685.6	6.6%
Sales & Use Tax	453.5	426.8	26.7	6.2%	2,826.1	2,814.6	11.5	0.4%
Corporate Income Tax	84.1	89.8	(5.7)	-6.4%	1,063.7	1,056.7	7.1	0.7%
Insurance	(0.9)	(37.3)	36.5	-97.7%	103.4	81.5	22.0	27.0%
Wills, Suits, Deeds	25.1	29.1	(4.0)	-13.9%	223.1	249.1	(26.0)	-10.4%
Interest Income	(50.1)	(49.0)	(1.1)	2.3%	444.7	438.6	6.1	1.4%
All Other	95.8	56.2	39.6	70.4%	411.3	413.6	(2.3)	-0.5%
Total GF Revenues	**$2,768.6**	**$2,427.7**	**$340.9**	**14.0%**	**$16,136.2**	**$15,432.1**	**$704.1**	**4.6%**
Total, Excl. NWH and Refunds	**$2,177.9**	**$1,843.9**	**$334.0**	**18.1%**	**$14,637.9**	**$14,218.1**	**$419.8**	**3.0%**

- Excluding non-withholding collections and refunds, which continue to be distorted by PTET-related activity are, general fund revenues are ahead of the forecast by 3.0 percent.
- Nonwithholding saw a meaningful decline in revenues reflecting lower January estimated payments and an apparent shift in taxpayer behavior as payers began to reduce or eliminate overpayments related to PTET.
- Withholding revenues exceeded projections by $242.2 million. The excess is due, in part, to unique timing issues.

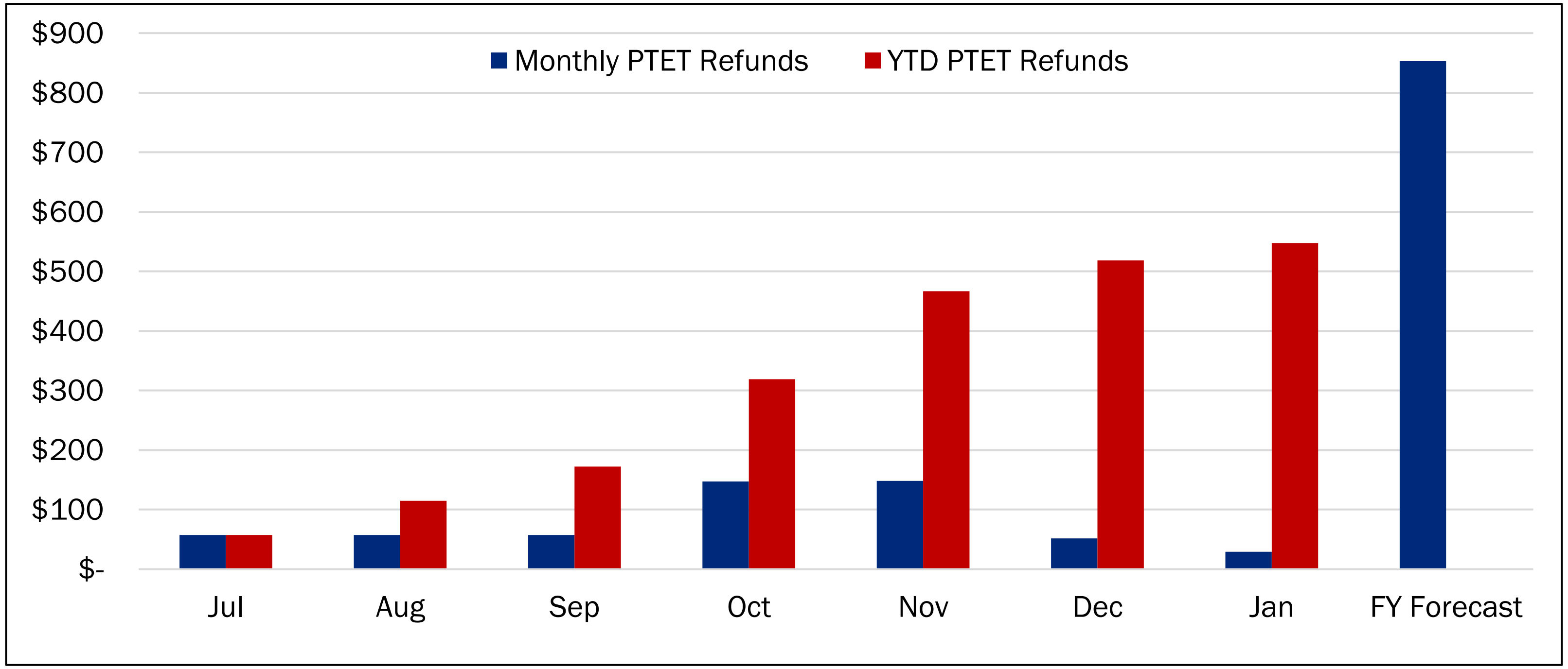
ADJUSTING FOR POLICY IMPACTS, GF REVENUES ARE UP 5.3 PERCENT

	January			Fiscal Year-To-Date		
Unadjusted Revenues	**FY 24 $**	**FY 23 $**	**Y/Y %**	**FY 24 $**	**FY 23 $**	**Y/Y %**
Withholding	$1,570.5	$1,321.7	18.8%	$9,565.5	$9,154.1	4.5%
Non-Withholding	656.9	905.7	-27.5%	2,689.6	2,815.2	-4.5%
Refunds	(66.2)	(56.8)	16.5%	(1,191.3)	(1,435.4)	-17.0%
Sales & Use Tax	453.5	468.9	-3.3%	$2,826.1	2,873.3	-1.6%
All Other	154.0	201.4	-23.5%	$2,246.3	1,920.4	17.0%
Total GF Revenues	2,768.6	2,840.9	-2.5%	$16,136.2	15,327.7	5.3%
Total Excluding NWH and Refunds	2,177.9	1,992.0	9.3%	$14,637.9	13,947.9	4.9%

	January			Fiscal Year-To-Date		
Adjusted Revenues	**FY 24 $**	**FY 23 $**	**Y/Y %**	**FY 24 $**	**FY 23 $**	**Y/Y %**
Withholding	$1,621.3	$1,321.7	22.7%	$9,856.8	9,154.1	7.7%
Non-Withholding	680.4	905.7	-24.9%	2,758.5	2,815.2	-2.0%
Refunds	(26.9)	(56.7)	-52.5%	(557.8)	(449.2)	24.2%
Sales & Use Tax	480.2	468.9	2.4%	2,987.4	2,945.6	1.4%
All Other	154.1	201.4	-23.5%	2,213.1	1,920.4	15.2%
Total GF Revenues	$2,909.1	$2,841.0	2.4%	$17,257.9	16,386.2	5.3%
Total Excluding NWH and Refunds	2,255.7	1,992.0	13.2%	15,057.3	14,020.2	7.4%

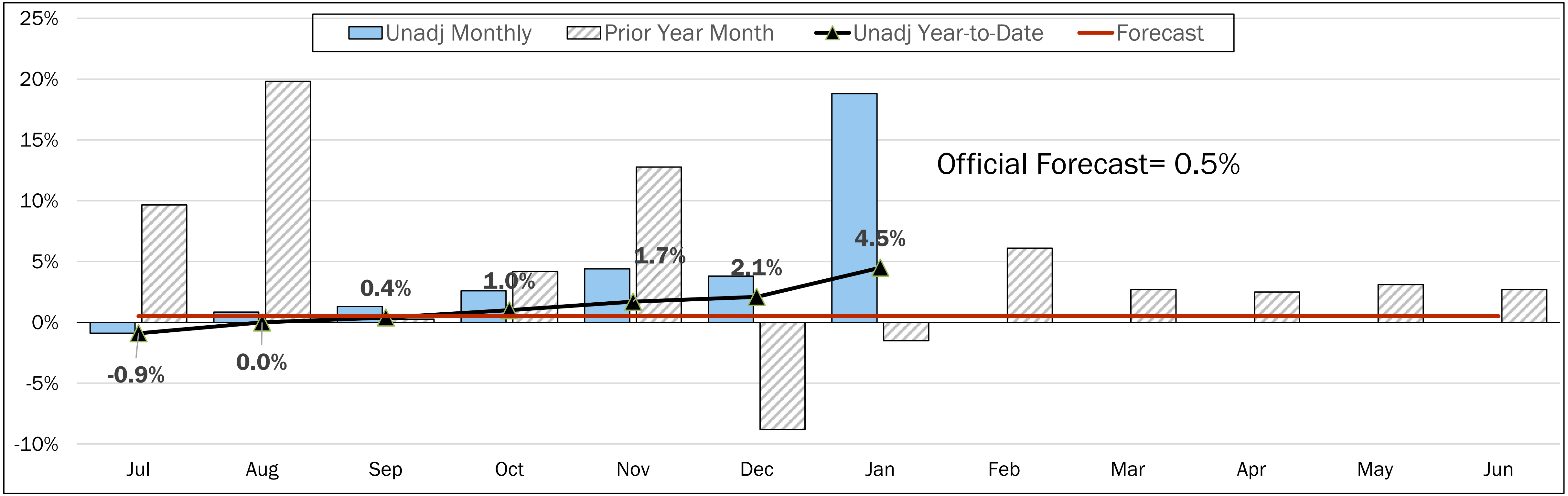
- Adjusting for policy actions reveals growth in withholding of 7.7 percent over last year.
- Meanwhile, January’s non-withholding numbers showed a year-over-year decline of 27.5 percent (24.9 percent adjusted).
- Sales tax has declined 1.6 percent year-over-year. Adjusting for the elimination of grocery tax, SUT has grown by 1.4 percent YTD.

PTET REFUND EXPECTATIONS AND RESULTS



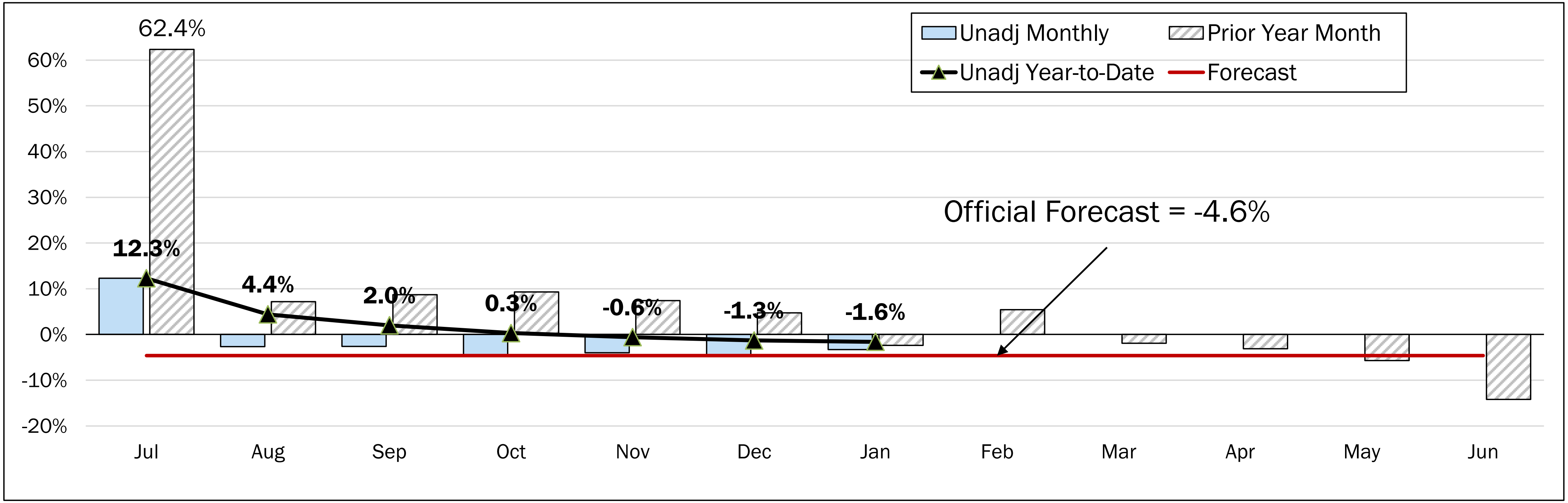
- After a flood of PTE owner returns in the second half of October, the Tax Department has processed and applied credits for over 10,000 such returns.
- Returns have significantly dropped since November.
- The forecast expects over $300 million in refunds to be processed in the new year, with the bulk falling in the filing season (February-April).

UNADJUSTED WITHHOLDING COLLECTIONS CONTINUE TO GROW



- Withholding collections grew 18.8 percent in January compared to January of last year.
- January collections were impacted by the timing of certain payroll withholding deposits, partly overstating results for the month.

GROWTH IN SALES TAX COLLECTIONS IS MODERATING AS EXPECTED



- The elimination of the state sales tax on groceries and personal hygiene products pushed forecasted sales tax revenue to -4.6 percent.
- Year-over-year decline in sales tax revenue is expected to stop after this month, as the base year (FY 2023) will also lack grocery tax revenues in February through June.

ECONOMIC OUTLOOK IS ESSENTIALLY UNCHANGED

December Forecast

- When the GACRE forecast was being developed, economists were essentially split 50/50 on the likelihood of a recession in the next twelve months. According to the October 2023 Wall Street Journal Economic Forecasting Survey, 31 out of 59 economists responded that a recession was more likely than not in the next twelve months.
- The GACRE forecast anticipated a recession beginning in Q4 of FY 2024 and lasting three quarters.
- General fund revenues decline 0.8 percent in FY 2024 and increase 3.0 percent in FY 2025. Growth accelerates to 6.5 percent in FY 2026.
- The December Forecast includes revenue impacts of the Governor's proposed tax policy actions for FY 2025 and FY 2026, a downward adjustment of $150 million in FY 2026 based on GACRE feedback, and minor technical changes. Otherwise, the forecast was unchanged from the GACRE forecast.

Mid-Session Forecast Update

- While in recent months, the view of some professional economists has turned more positive, a significant share of respondents to the January WSJ survey (38 percent) still see a 50 percent or greater likelihood of recession in the next year.
- Given conflicting economic data and ongoing macroeconomic risks and uncertainties, our prudent outlook for a mild U.S. recession is essentially unchanged.
- The outlook assumes that the U.S. economy slips into recession in the fourth quarter of FY 2024 as the lagged effects of high interest rates impact corporate profits, further curtail housing market activity, and reduce consumer spending.
- The spend down of pandemic savings and deteriorating consumer balance sheets will impact consumer spending and dampen economic growth further before rebounding in calendar year 2025.

MID-SESSION FORECAST UPDATE

- <u>We are recommending no adjustments to the revenue forecast at this time</u>.
- FY 2024 total Revenue collections on a year-to-date basis are running slightly ahead of the forecast. Performance of the major sources is mixed.
- Payroll withholding collections were generally on plan for the first six months of the fiscal year. January exceeded expectations, driven partially by a unique timing issue while recent declines in Virginia employment support a cautious approach.
- Sales tax collections are down 1.6 percent year-to-date, modestly ahead of the forecast.
- Individual income tax nonwithholding revenues were ahead of projections through December. However, January collections were down a surprising 27.5 percent. January estimated payments often provide insight into final tax payments, which could imply that final payments will be significantly lower if the decline experienced in January continues into the fourth quarter.
- Wills, suits, and deeds (mainly recordation) is down 14.4 percent year-to-date, below the annual forecast of a 1.2 percent decline.