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Economics Group

Special Commentary

Tim Quinlan, Senior Economist
tim.quinlan@wellsfargo.com • (704) 410-3283
Michael Pugliese, Economist
michael.d.pugliese@wellsfargo.com • (212) 214-5058
Shannon Seery, Economic Analyst
shannon.seery@wellsfargo.com • (704) 410-1681

Refund Status: Still Processing

Tax Refunds Are Running Behind & Coming Up Short, but That Could Change

Fewer people are filing taxes early this year, and those who are have seen tax refunds down on average 17.0% versus this period last year. An inauspicious start does not necessarily mean that tax refunds are sure to be lower for the year, but, should this trend continue, it poses a potential threat to Q1 GDP growth.

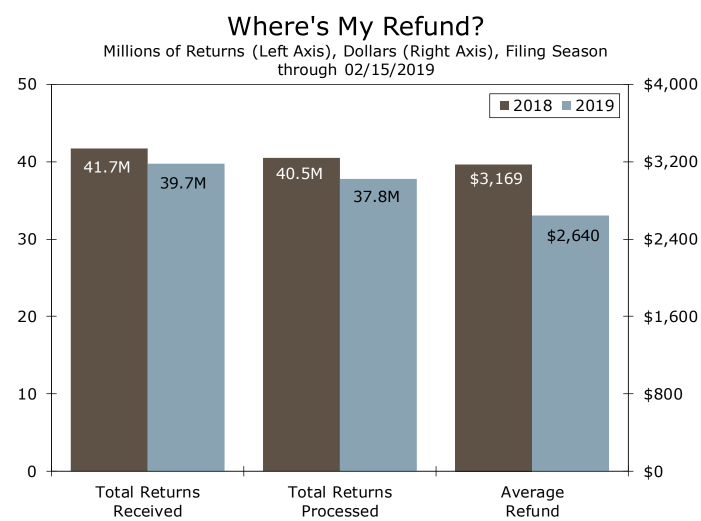
The tax cuts passed in the final days of 2017 resulted in increased after-tax income for most households. However, due to a number of factors (changes in withholdings, the government shutdown, etc.) there remains considerable uncertainty about how much of that gain was realized in calendar year 2018 and how much will (or will not) be realized during the filing season. In this short special report, we unpack the factors that complicate this issue and offer a practical way to monitor this year's refunds. Although refunds have been down both in the aggregate and on average so far, we believe there is some upside risk that this could at least partially reverse in the coming weeks. *What is known*: so far, the pace of filings and size of returns is slower than prior years. *What is unknown*: whether once the dust settles the actual aggregate amount and average refund will still be down as precipitously as they are so far. If refunds are still down after another few weeks, we believe there could be some downside risk to our Q1 consumer spending forecast.

Lower tax refunds to date present some potential risk to our outlook for Q1 consumption.

Most Americans Give the IRS an "Interest-Free Loan"

A fat refund check can be a windfall to fuel consumer spending on big-ticket durable goods. Thus far, with roughly 25% of returns received and processed, it appears that refunds may offer less of a boost than in recent years.

Figure 1



Source: Internal Revenue Service and Wells Fargo Securities

Together we'll go far

Through February 15, 2019, the Internal Revenue Service (IRS) had received just 39.7 million tax returns, a roughly 2 million decrease over this time last year, or a decline of 4.8% (Figure 1). Despite the slower pace of filing, it is also evident that the IRS is having a more difficult time keeping up. Only about 38 million returns have been processed to date, a 6.6% decline compared to 2018. When it comes to the total amount of refunds issued, the decline is an even larger 38.8% compared to the same period in 2018.

So what is going on here? There are a few different factors at play. When the tax cuts were passed in late 2017, the IRS adjusted the income-tax withholding tables to reflect some of the changes in law, such as the increase in the standard deduction and changes in tax rates and brackets. However, the withholding tables do not tell the full story; to fully account for the tax changes that occurred, the IRS also had to release a new W-4 form. This new form became available on February 28, 2018 and was designed to reflect changes in the law not reflected in the withholding tables, such as the available itemized deductions and increases in the Child Tax Credit. Unlike the withholding table changes, which most employers would have begun using unilaterally, many employees would have had to proactively change their W-4 based off their individual circumstances.

Most households likely saw a lower tax liability, but household tax refunds will likely vary.

In the aggregate, most households in 2018 likely saw a lower tax liability as a result of the tax cuts (Table 1).[1] What is less clear, however, is what percentage of that tax cut was realized in 2018 versus what will be (or will not be) realized when filing in 2019. So, while the after-tax income boost for most households is generally positive, due to variability in tax withholdings and individual responses, the tax refunds that households receive will vary. The truest statement that we can offer in terms of setting expectations about the size of tax refunds this year is that nobody really knows precisely how the filing season will play out.

Table 1

Distributional Effects of "Tax Cuts & Jobs Act"

Income Category	Change in 2019 Federal Taxes	
	Millions	Percent
Less than $10,000	-$396	-5.6%
$10,000 to $20,000	-$1,792	*
$20,000 to $30,000	-$2,982	-13.5%
$30,000 to $40,000	-$5,416	-11.5%
$40,000 to $50,000	-$6,728	-10.0%
$50,000 to $75,000	-$23,046	-8.7%
$75,000 to $100,000	-$22,437	-8.0%
$100,000 to $200,000	-$70,372	-7.5%
$200,000 to $500,000	-$65,485	-9.0%
$500,000 to $1,000,000	-$23,947	-9.4%
$1,000,000 and over	-$36,853	-5.9%
Total, All Taxpayers	**-$259,454**	**-8.0%**

*** For returns in the $10,000 to $20,000 income category, Federal taxes would decrease from -$2.414 billion to -$4.204 billion**

Source: Joint Committee on Taxation and Wells Fargo Securities

Although the preliminary reporting data show that the average tax refund is down so far, we are not convinced this should be taken as a confirmation that refunds will decline across the board once filing season is complete. In July 2018, the Government Accountability Office (GAO) interviewed representatives from the IRS, Treasury and outside organizations including the American Payroll Association and the American Institute for Certified Public Accountants. While the GAO advocated for more thoroughness in withholding guidelines, it did not communicate any clear expectation about over- or under- withholding, which would ultimately influence the size of tax refunds this year.[2]

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[1] **Joint Committee on Taxation. "Distributional Effects of The Conference Agreement for H.R.1, The 'Tax Cuts and Jobs Act.'"**

[2] **United States Government Accountability Office (GAO). "Federal Tax Withholding: Treasury and IRS Should Document the Roles and Responsabilities for Updating Annual Withholding Tables." July 2018.**

The same report said that Treasury "aimed to minimize under-withholding among certain groups of taxpayers, such as low-income taxpayers and taxpayers who itemize deductions." To the extent that these efforts were successful, we could reasonably expect low-income consumers would not see diminished tax-returns. That is a call long-maintained by our own consumer equity research colleagues who anticipate increased spending by lower-income households this year and increased sales at the retailers who service them.

The slow pace of filing and processing may in part reflect the shutdown.

In part, the slow pace of filing and processing may simply reflect the lingering effects of the government shutdown. Even before the shutdown, the 2019 filing season was likely to be more onerous and uncertain than usual, as this will be the first filing for most individuals since the Tax Cuts and Jobs Act took effect. The loss of valuable preparatory time over the month of January for the IRS has introduced an additional element of uncertainty.

The refund outlook may also be influenced by some anti-fraud rules utilized by the IRS. Filers who claim the Earned Income Tax Credit (EITC) or the refundable portion of the Child Tax Credit (CTC) typically experience a refund hold because current law stipulates that the IRS cannot issue these refunds before mid-February. In fact, the IRS expects refunds tied up with these programs to be available in taxpayer bank accounts or debit cards starting February 27, 2019.[3]

This policy of holding refunds is not new compared to last year, but the later start to filing season means the delay has also been pushed back, creating some timing noise in the year-over-year comparisons. Furthermore, if households that are beneficiaries of the aforementioned tax credits are also in-line to see larger refunds as a result of the tax bills, then refunds could jump in the coming weeks. Indeed, back in December 2017 the Joint Committee on Taxation estimated that households in the $20,000-$50,000 range would see some of the largest percentage change declines in their tax liabilities.[4] The Child Tax Credit alone was estimated to reduce federal tax revenues by about $70 billion in 2019. While not all of that benefit is likely to be realized during refund season, there is a very real possibility that a large chunk of it is currently being delayed due to the aforementioned rules. If this is indeed true, we would expect to see refunds jump in the weeks ahead, or at least see a much smaller decline compared to what has been seen so far. Fortunately, these data can easily be tracked on a week-to-week basis via the IRS's filing season statistics webpage.[5]

Figure 3

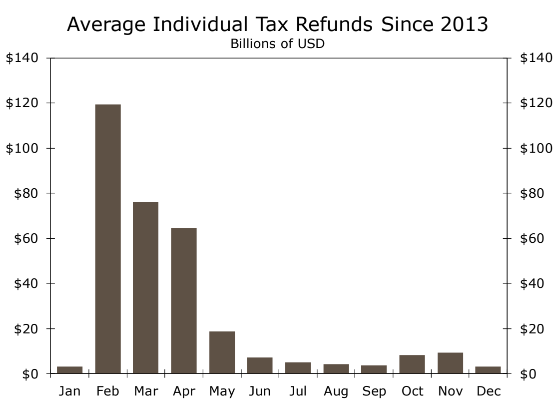
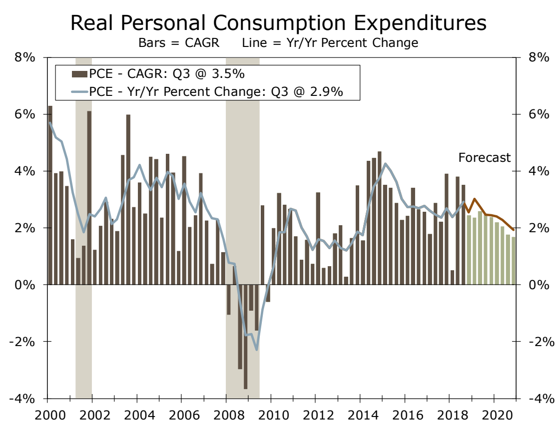


Figure 4



Source: U.S. Department of the Treasury, U.S. Department of Commerce and Wells Fargo Securities

Consumer Spending Was Already Going Through a Tough Period

February is the largest month for tax refunds.

But what if aggregate/average refunds continue to lag behind last year's pace over the next few weeks? Under that scenario, it appears the first two months of 2019 could be negatively affected.

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3 IRS. Refund Timing for Earned Income Tax Credit and Additional Child Tax Credit Filers.
4 Reference footnote 1.
5 IRS. Filing Season Statistics by Year.

As Figure 3 shows, over the past five years February typically is the largest month of the year for tax refunds, so anything that inhibits that windfall is likely to be a headwind for Q1 spending growth. If the aggregate amount of refunds is still down 38.8% come the end of March (unlikely in our view), this would be $82 billion less than what was issued in 2018. Were this money entirely spent in the quarter, this would represent approximately 2.3% of consumer spending in Q1; not a huge share, but certainly not something to ignore either. While the conventional wisdom might suggest you should not give the government what amounts to an interest-free loan, it is clear that a large number of Americans still set their withholdings such that they get a refund when they file their taxes. In 2018 for example, the number of refunds issued by the IRS was about 112 million, or 72.4% of the roughly 154 million tax returns received.

The timing would be unfortunate as consumer spending has already run into a significant soft patch in recent months. The Conference Board's measure of consumer confidence has fallen in three consecutive months, and retail sales cratered in December, posting the biggest one-month drop since the recession year of 2009. The retail sales report was also delayed by the government shutdown and one-off reports about reporting glitches and timing issues, which likely means the weakness in December was overstated; we do not have any other evidence of consumers going into hiding. That said, our forecast for real personal consumption expenditures looks for a moderation in the pace of growth throughout the next couple of years (Figure 4).

Conclusion: Refunds Are a Function of Withholding

Timing of tax returns is running behind, but that does not mean smaller refunds are certain for 2019.

The bottom line from our perspective is that the timing of tax returns might be running a few weeks behind. February and March are far-and-away the biggest months for tax returns; taxpayers may give the government an interest-free loan, but they want the money back as soon as they can get it. The size of the average refund is down so far, but that does not necessarily mean smaller refunds once it is all said and done.

The smaller refunds at the outset and the fact that the IRS is running a little behind its usual processing schedule mean that some durables spending could be put off into March or perhaps into the second quarter. Lower-income consumers are expected to benefit from the expansion of the Child Tax Credit, and increased spending here could offset any softening in consumer durable outlays.

We will continue monitoring the tax collection data to inform our thinking as it relates to the timing of consumer spending in the first half of 2019. Lower levels of consumer confidence and a puzzling December report for retail sales suggest a moderation in the pace of consumer spending. While tax refunds present another potential obstacle to growth in the first quarter, we believe the data so far are overstating the pace of decline. The notion that smaller tax refunds presage a significant drop-off in consumer spending is ill-founded, in our view.

Wells Fargo Securities Economics Group

Jay H. Bryson, Ph.D.	Global Economist	(704) 410-3274	jay.bryson@wellsfargo.com
Mark Vitner	Senior Economist	(704) 410-3277	mark.vitner@wellsfargo.com
Sam Bullard	Senior Economist	(704) 410-3280	sam.bullard@wellsfargo.com
Nick Bennenbroek	Macro Strategist	(212) 214-5636	nicholas.bennenbroek@wellsfargo.com
Azhar Iqbal	Econometrician	(212) 214-2029	azhar.iqbal@wellsfargo.com
Tim Quinlan	Senior Economist	(704) 410-3283	tim.quinlan@wellsfargo.com
Sarah House	Senior Economist	(704) 410-3282	sarah.house@wellsfargo.com
Charlie Dougherty	Economist	(704) 410-6542	charles.dougherty@wellsfargo.com
Erik Nelson	Macro Strategist	(212) 214-5652	erik.f.nelson@wellsfargo.com
Michael Pugliese	Economist	(212) 214-5058	michael.d.pugliese@wellsfargo.com
Brendan McKenna	Macro Strategist	(212) 214-5637	brendan.mckenna@wellsfargo.com
Shannon Seery	Economic Analyst	(704) 410-1681	shannon.seery@wellsfargo.com
Matthew Honnold	Economic Analyst	(704) 410-3059	matthew.honnold@wellsfargo.com
Donna LaFleur	Executive Assistant	(704) 410-3279	donna.lafleur@wellsfargo.com
Dawne Howes	Administrative Assistant	(704) 410-3272	dawne.howes@wellsfargo.com

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