# The Economy … Its Impact On Virginia's Budget

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House Appropriations Committee
November 16, 2010

# True Statements

“The economy is growing at a pace less vigorous than we would like"

- Federal Reserve Chairman Bernanke

“Without more jobs, consumer spending is going to be weak, which is why retail sales are far weaker than in prior recoveries”

- Jim Welsh, Welsh Money Management

“The eggheads say the recession is over…But it still feels like one out there”

- Ken Goldstein, Conference Board

“Tax revenues generally lag the recovery due to the lagging nature of employment growth – the only short term economic indicator that matters is money in the bank”

- Robert Vaughn, HAC Staff Director

# How Did The 2007 Recession Compare To Previous Recessions?

*Recessions since World War II*

| | Duration in Months | | Peak to Trough % Change | | | | | |
|---|---|---|---|---|---|---|---|---|
| | | | | | | | | |
| Peak | Trough | Recession Peak to Trough | Expansion Peak to Trough | Real GDP | Industrial Production | Non Farm Employment | | Jobless Rate | |
| | | | | | | | Low | High | Change |
| **December 2007** | **August 2009** | **20** | **73** | **-3.9%** | **-19.2%** | **-5.5%** | **4.4%** | **10.1%** | **5.7%** |
| March 2001 | November 2001 | 8 | 120 | -0.4% | -6.3% | -2.0% | 3.8% | 6.3% | 2.5% |
| July 1990 | March 1991 | 8 | 92 | -1.3% | -4.3% | -1.5% | 5.0% | 7.8% | 2.8% |
| July 1981 | November 1982 | 16 | 12 | -2.9% | -9.5% | -3.1% | 7.2% | 10.8% | 3.6% |
| January 1980 | July 1980 | 6 | 58 | -2.2% | -6.2% | -1.3% | 5.6% | 7.8% | 2.2% |
| November 1973 | March 1975 | 16 | 36 | -3.1% | -14.8% | -2.7% | 4.6% | 9.0% | 4.4% |
| December 1969 | November 1970 | 11 | 106 | -1.0% | -5.8% | -1.4% | 3.4% | 6.1% | 2.7% |
| April 1960 | February 1961 | 10 | 24 | -1.3% | -6.2% | -2.3% | 4.8% | 7.1% | 2.3% |
| August 1957 | April 1958 | 8 | 39 | -3.8% | -12.7% | -4.4% | 3.7% | 7.5% | 3.8% |
| July 1963 | May 1954 | 10 | 45 | -2.7% | -9.0% | -3.3% | 2.5% | 6.1% | 3.6% |
| November 1948 | October 1949 | 11 | 37 | -1.7% | -8.6% | -5.1% | 3.4% | 7.9% | 4.5% |
| | | | | | | | | | |
| **Average** | | **10** | **57** | **-2.0%** | **-8.3%** | **-2.7%** | **4.4%** | **7.6%** | **3.2%** |
| | | | | | | | | | |
| Sources: NBER, BEA, FRB, Moody'sEconomy.com | | | | | | | | | |

# A Guide To A Recovery

- Industrial production and corporate profits can be leading indicators of a recovery
- Job gains generally lag in a recovery
- Consumer spending accounts for two-thirds of total economic activity
  - Recovery cannot fully engage without consumers
- While economic indicators signal the direction of the economy, the inflection point – the point at which the recovery fully engages – is hard to predict

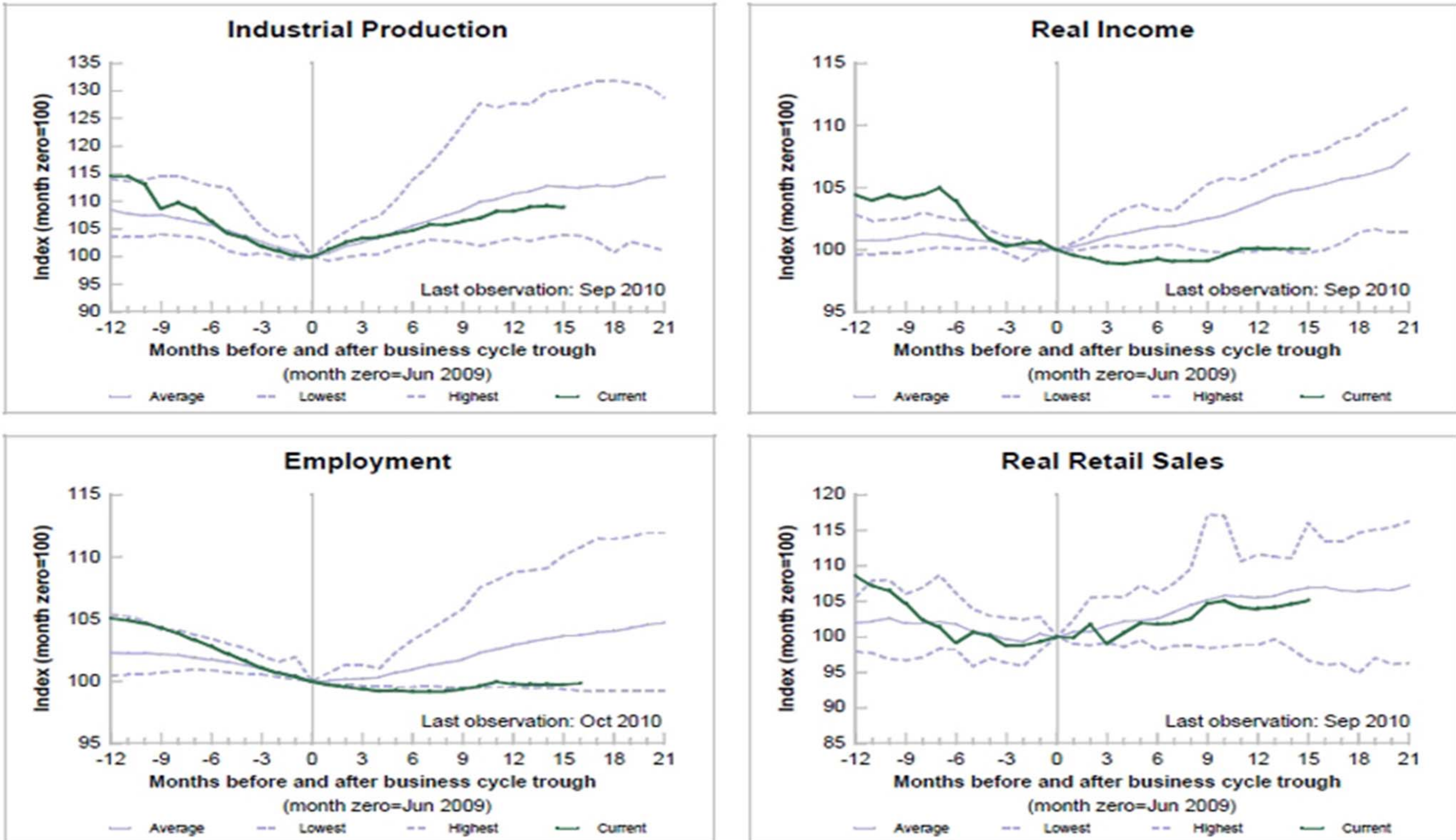
# If Not an Expansion or a Double Dip, Then What?

*The recovery has zigzagged since the "official" end of the recession*

- The U.S. economy may be experiencing a growth recession
  - An economy that is growing at such a slow pace that the lack of job creation makes it "feel" as if the economy is in a recession even though the economy is still advancing
- Nationally, unemployment remains high, with job growth below that needed to absorb new entrants
- Companies have been showing some willingness to hire and increase hours worked
- But, continue to hoard cash, in part because of the uncertain economic recovery and the fear that they won't have access to credit
- Consumers remain cautious, spending primarily on replacement items

# How Has The Economy Fared Since the Trough?

*Growth Since the "Official" End of The Recession*




*Data last updated 2010-11-05.*

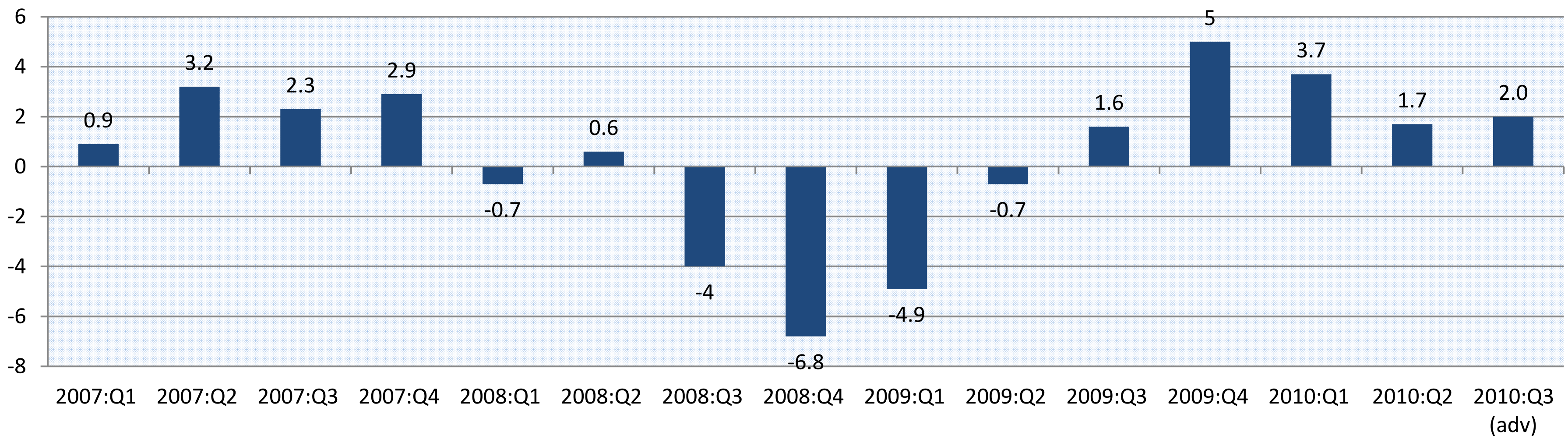
# The Recession Is Really Over,  But Growth Is Not As We Would Want It

Federal Intervention, GDP, Jobs, Consumer Spending, and Housing?

# Despite Unprecedented Federal Intervention, It Didn't Produce A Bounce

- Unlike at the beginning of previous recessions, the Federal Funds rate is at historic lows, standing at 1% when recession started compared to 8% in 1991 and 5% in 2001
  - Typically, once in a recession, the Federal Reserve begins to lower the Federal Funds rate in order to stimulate spending
  - Indications are the rate will stay in the 1% range for the near future
- In order to further stimulate the economy, the Federal Reserve implemented Quantitative Easing (QE I and QE II) which resulted in the purchase of US Treasuries in order to keep long-term interest rates low and to spur the housing recovery and business expansion
  - While this strategy has keep interest rates low, tight credit, higher loan standards, and stubborn unemployment have undermine the impact
  - This strategy favors borrowers over savers
- Federal stimulus funding mitigated cuts to state and local government, and provided for infrastructure investment
  - Contained programmatic spending that ends this year
  - Created a "cliff effect" for state and local governments

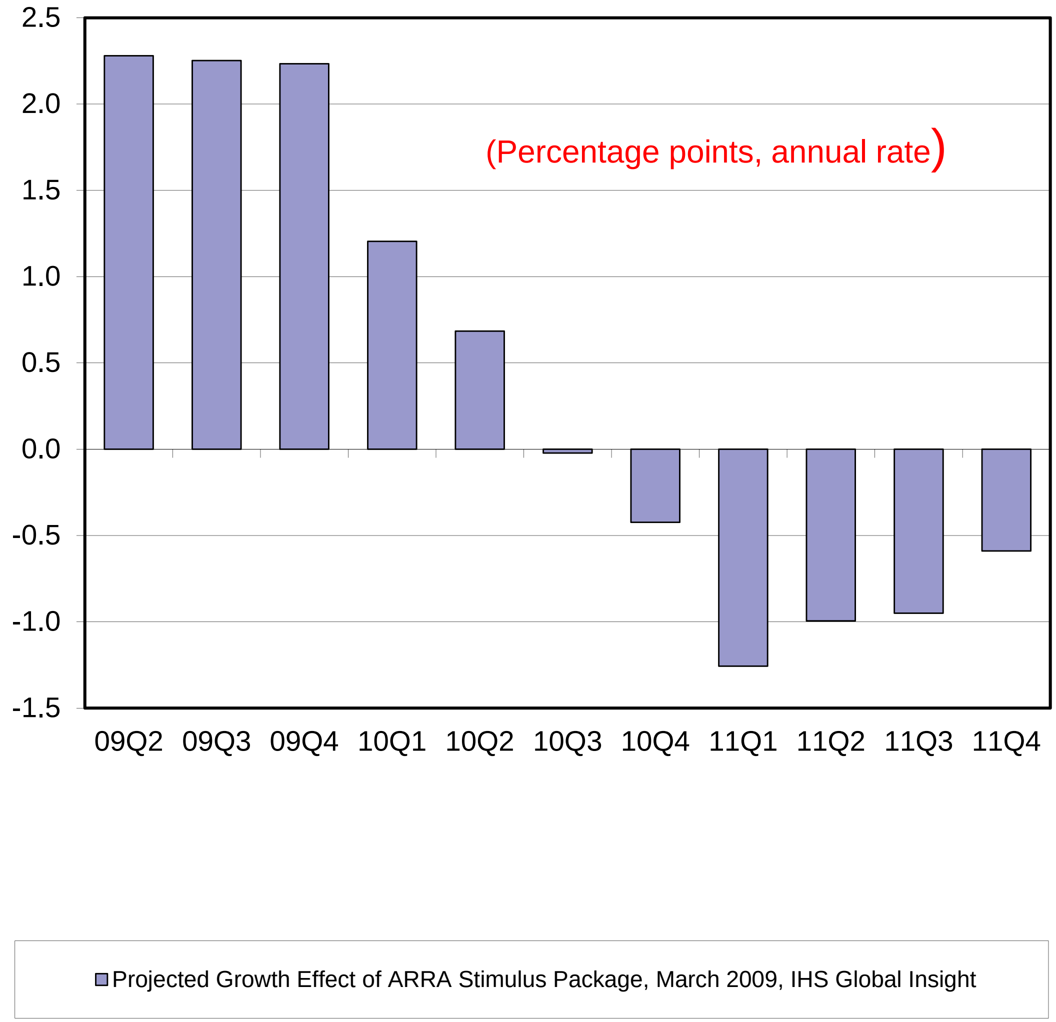
# Five Consecutive Quarters of Positive GDP, But Is Recent Data Portending a Slowdown or Is GDP Really Stronger?



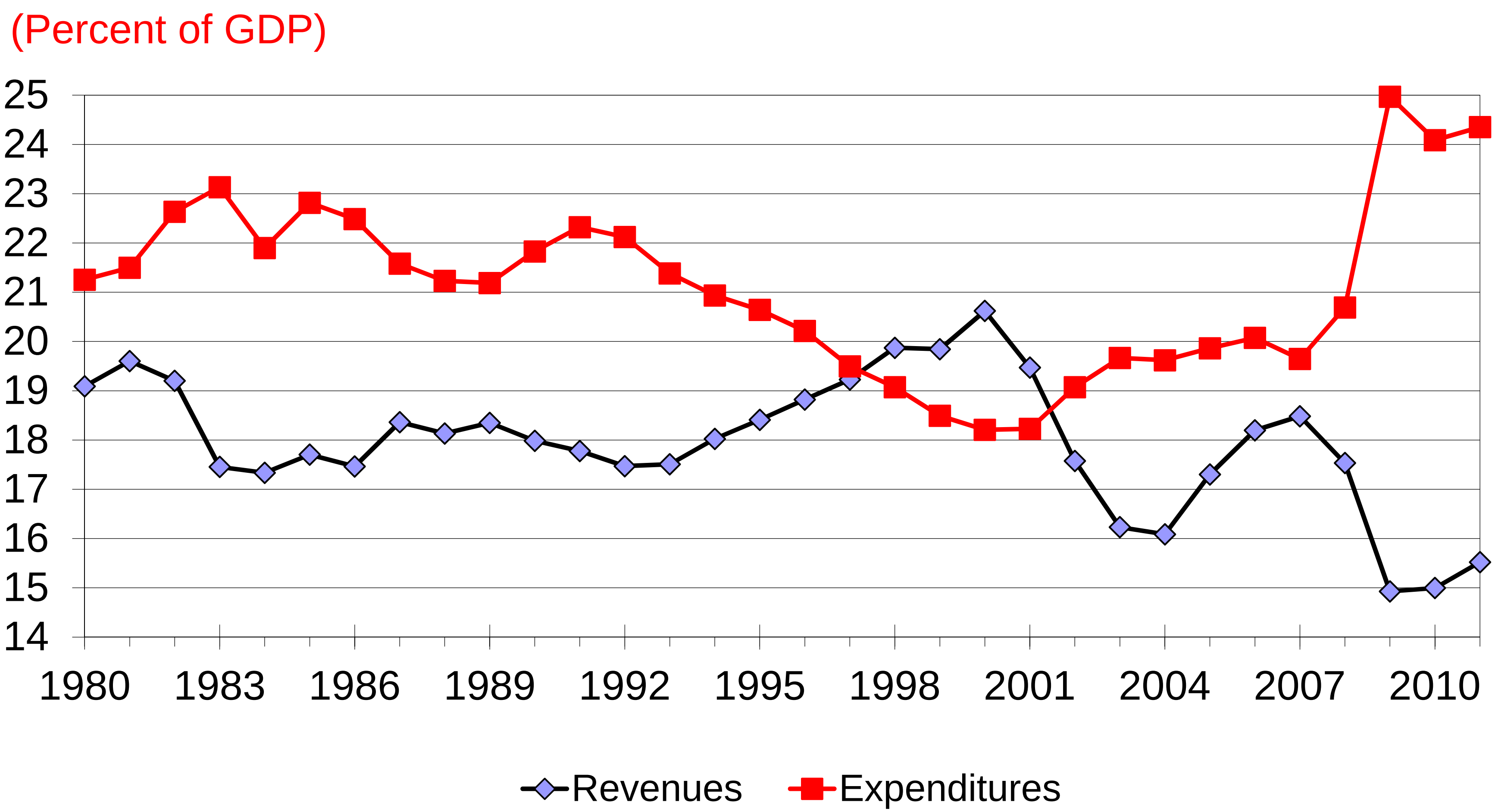

- The third quarter GDP is based on preliminary data and primarily reflects positive contributions from personal consumption expenditures (PCE), private inventory investment, nonresidential fixed investment, federal government spending, and exports that were partly offset by a negative contribution from residential fixed investment
  - Imports, **which are a subtraction** in the calculation of GDP, increased 17%
- Second quarter GDP includes the final revisions and primarily reflected positive contributions from personal consumption expenditures, nonresidential fixed investment, exports, private inventory investment, federal government spending, and residential fixed investment
  - **Sharp acceleration in imports which increased 33.5 percent compared with an increase of 11.2 percent the previous quarter, help explain the softness in GDP growth**
  - Federal spending continues to add positively to overall GDP, but it's impact will wane as the stimulus abates

# Growth Boost From Federal Stimulus Is Fading

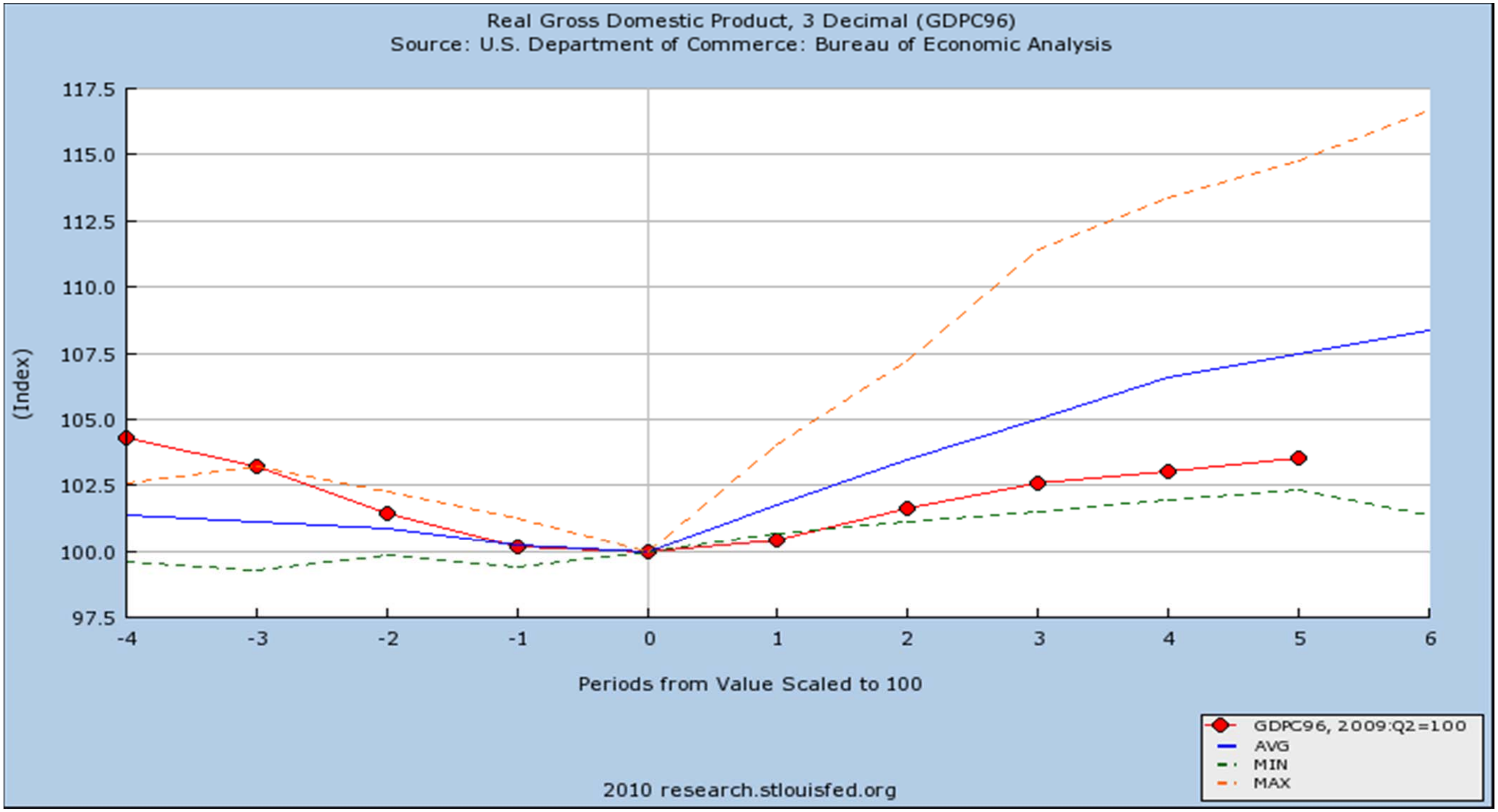
- Some question whether cash-for-clunkers and first time home buyer credit merely borrowed from future activity
  - Reflected in Global Insight's impact analysis
- Most of the stimulus funding designed to assist state and local governments ends in FY 2011, resulting in a cliff effect and further reductions in spending
- Federal spending, while helping GDP, comes with a huge cost in terms of the federal deficit and higher interest rates in the near future



# The Federal Budget Gap



# Current GDP Compared to Previous Expansions Indicates Gradual Growth



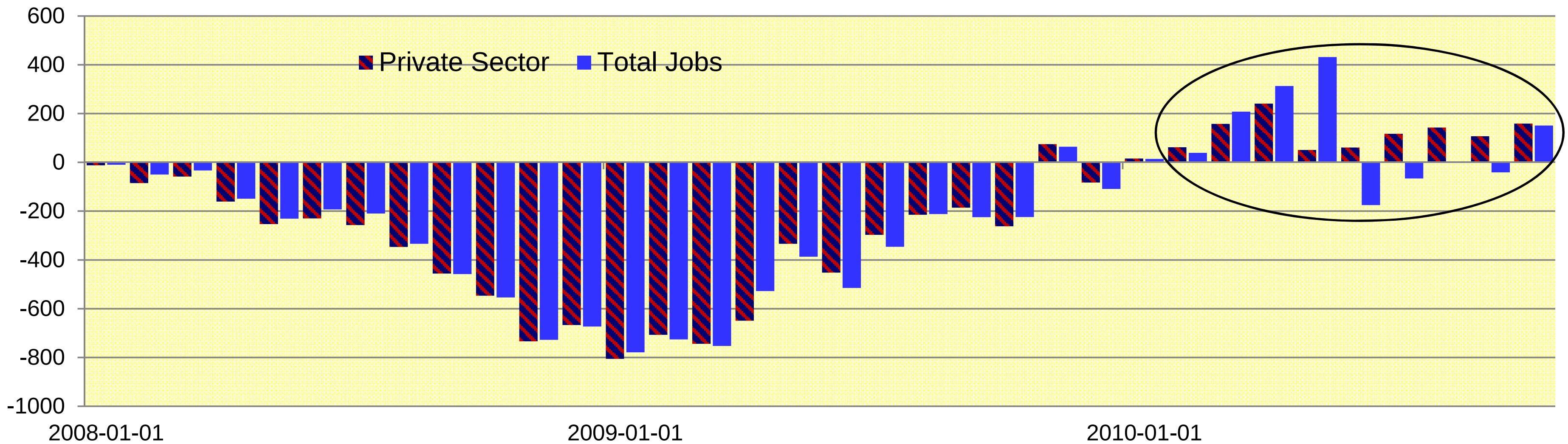
# Looking Beyond GDP -- What are the Key Economic Indicators Telling us?

ISM Index Signals Expansion, But Does Employment Remain the Achilles Heel?

# Employment Is Turning, But Not Rapidly

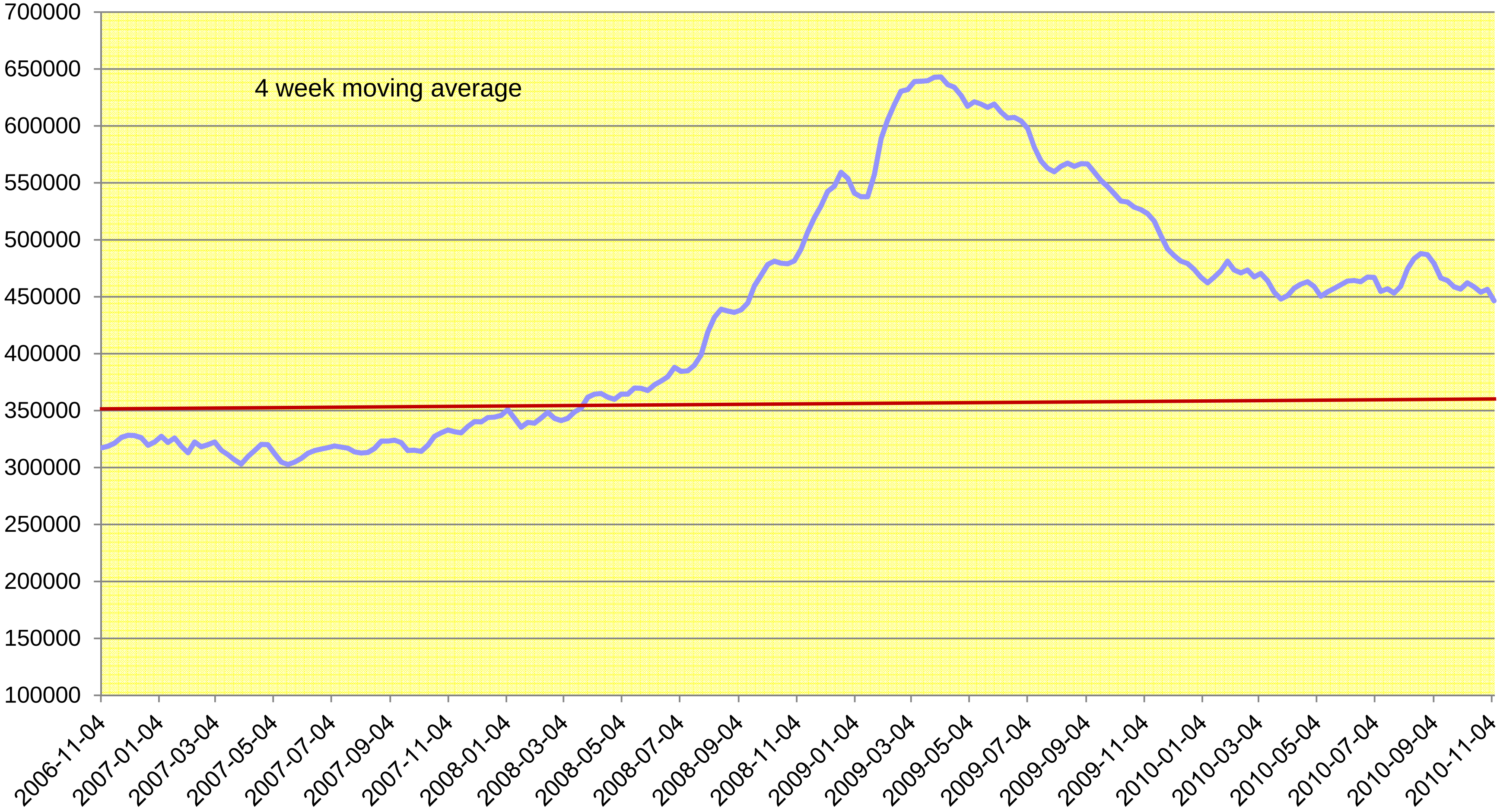
- Since the recession began in December 2007, a total of 7.8 million jobs have been lost nationally
  - October's year-over-year comparisons show the economy has added over 829,000 total jobs
- Since December 2009, the economy has created **1,115,000 private sector jobs**, or about 111,500 per month – still the economy needs to create 125,000 jobs just to absorb new entrants to the labor market
- The difference between total jobs and private sector reflects employment declines in the government sector, primarily among temporary workers hired for the 2010 Census and local government employment
- Manpower's quarterly survey of 18,000 firms reveals a net employment outlook of 5% growth in the fourth quarter, however, 71% of the firms plan no change in hiring
  - 11 out of 13 industry sectors report a positive outlook
- Mass layoff announcements have declined for 3 consecutive months, with 13 out of 19 sectors reporting declines in the number of layoffs
  - Improvement is reflected in the initial unemployment claims
- Most companies continue to meet their additional labor needs by either increasing the hours worked per week or by adding temporary workers; the recovery of the labor market will take some time

# Private Sector Employment -- The Silver Lining?



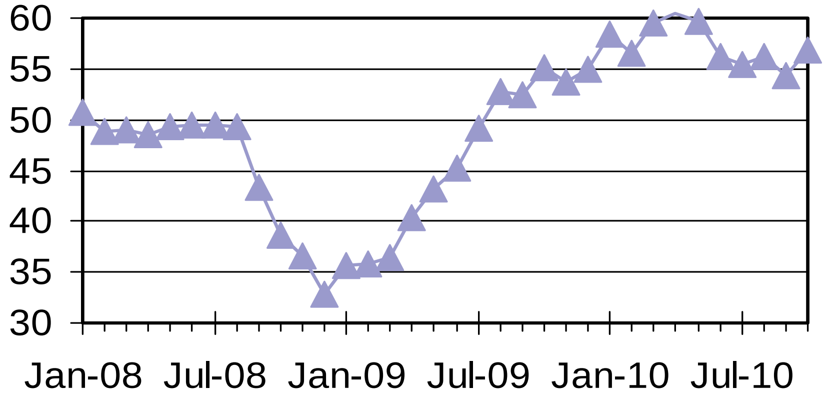

- The private sector has experienced 10 consecutive months of employment gains – average about 111,500 per month
- Job gains have been across a broad range of sectors with Professional & Business Services experiencing the greatest gains followed by: Leisure and Hospitality; Manufacturing; and, Trade, Transportation and Utilities
  - 3 sectors continue to experience job loss: construction, finance, and information services
- The economy (GDP) will need to grow twice the rate in order to begin to lower the unemployment rate

# Initial Unemployment Claims, Receding From Their Peak, But *Economists Are Looking For A Reading Of 350,000*

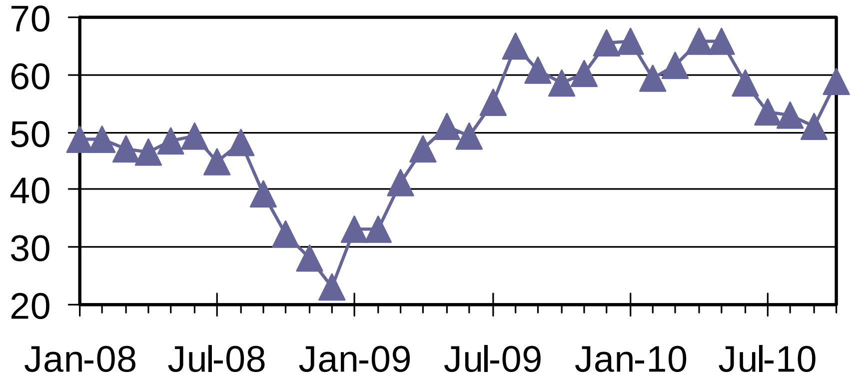


# Manufacturing Sector Continues to Expand -- 15 Consecutive Months, with 14 of 18 Manufacturing Industries Reporting Growth in October

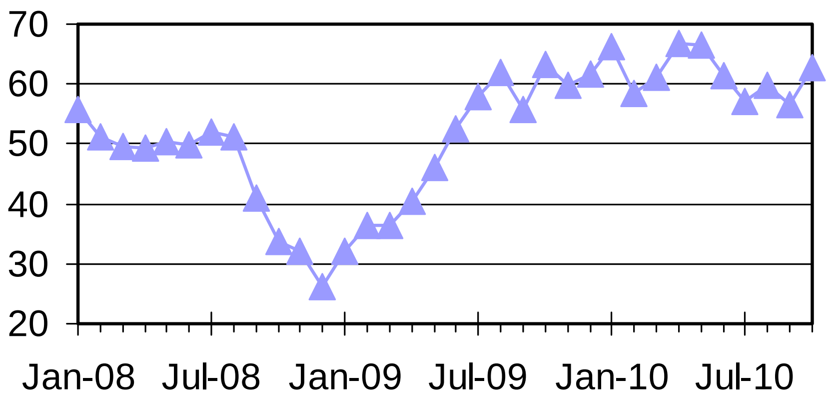
**ISM Manufacturing Index**



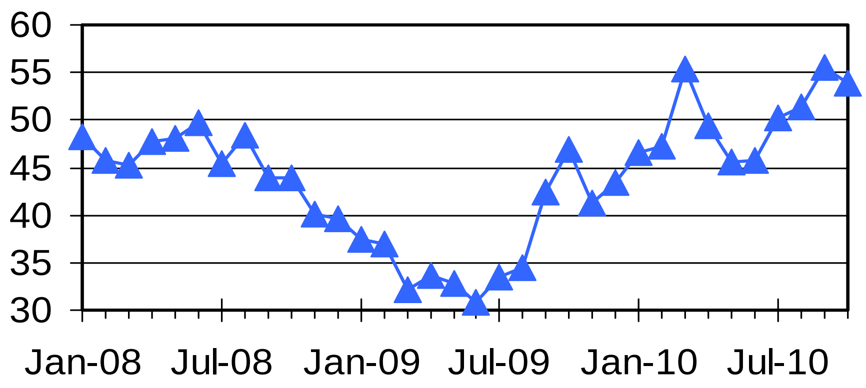

**ISM Manufacturing New Orders Index**




**ISM Manufacturing Production Index**



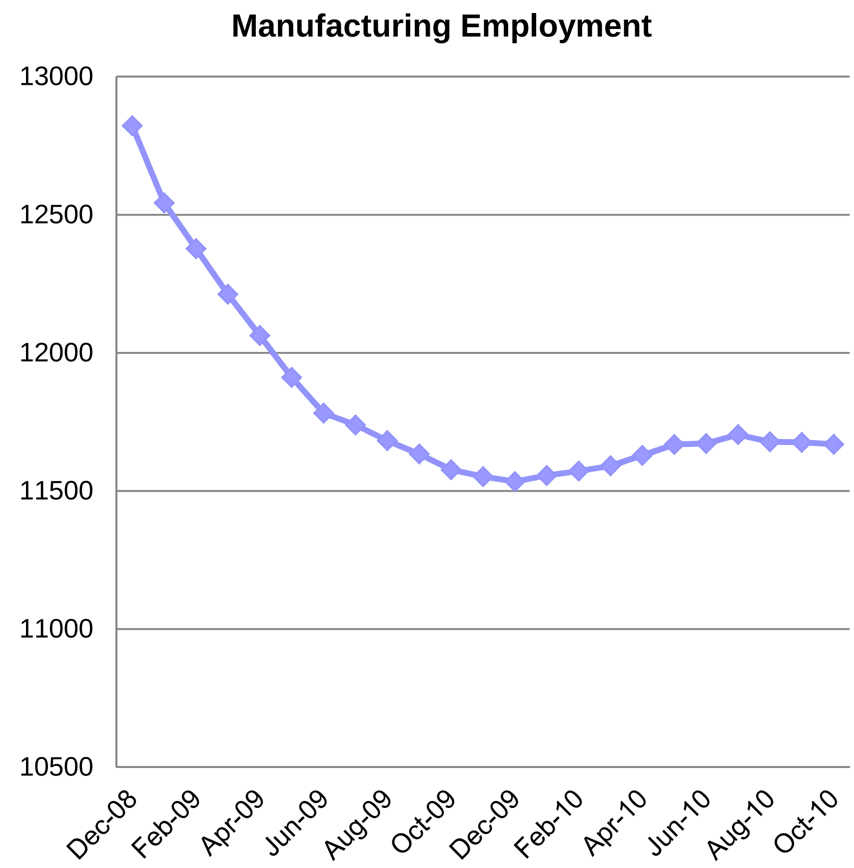

**ISM Manufacturing Inventories Index**




All indicators are diffusion indexes

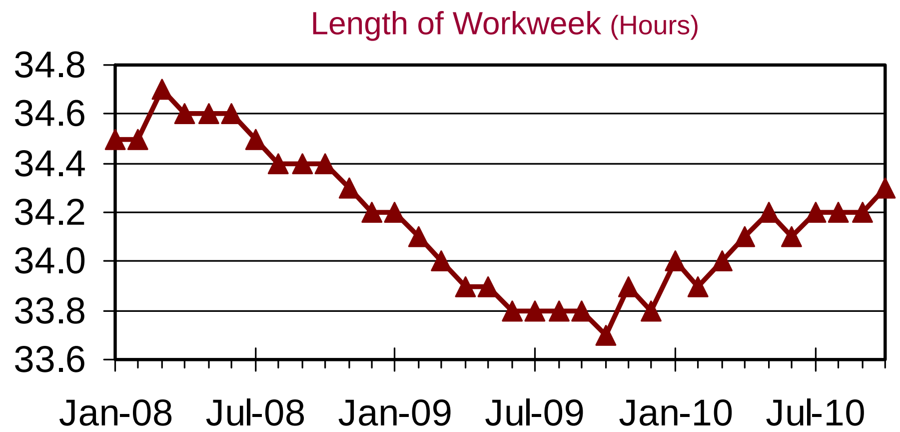
# Manufacturing Employment Slow To Recover, But Unlike Construction, There Have Been Job Gains

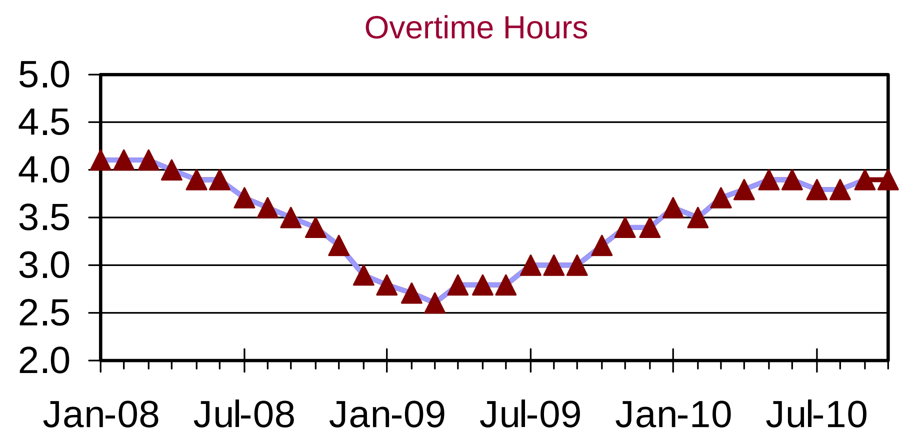
- Manufacturing, which accounts for 9% of the nations employment loss 2.2 million jobs (28% of total job loss)
- October's ISM data suggests stronger economic growth in the 4th quarter
- October represented the 15th consecutive month of growth, with 14 of the 18 industries reporting growth
- New orders and production, a strong indicator of future growth, jumped significantly
  - Export and autos are a big source of the growth
- Since hitting bottom in December 2009, manufacturing has seen several monthly gains totaling 135,000 jobs



# Lenghtened Workweek and Overtime Fill Manufacturing Demand

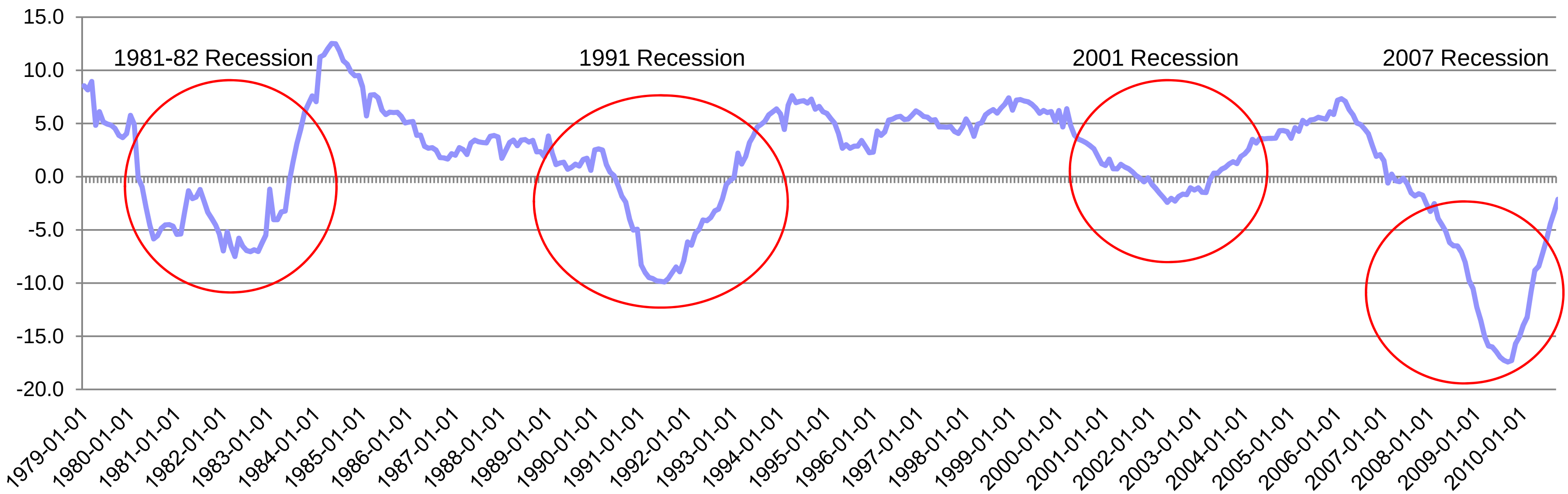
- While the employment index grew, companies continue to be cautious in their hiring, relying on productivity, lengthened workweek, overtime, and temporary employees to meet demand



# U.S. Construction Employment - Not Leading The Recovery This Time

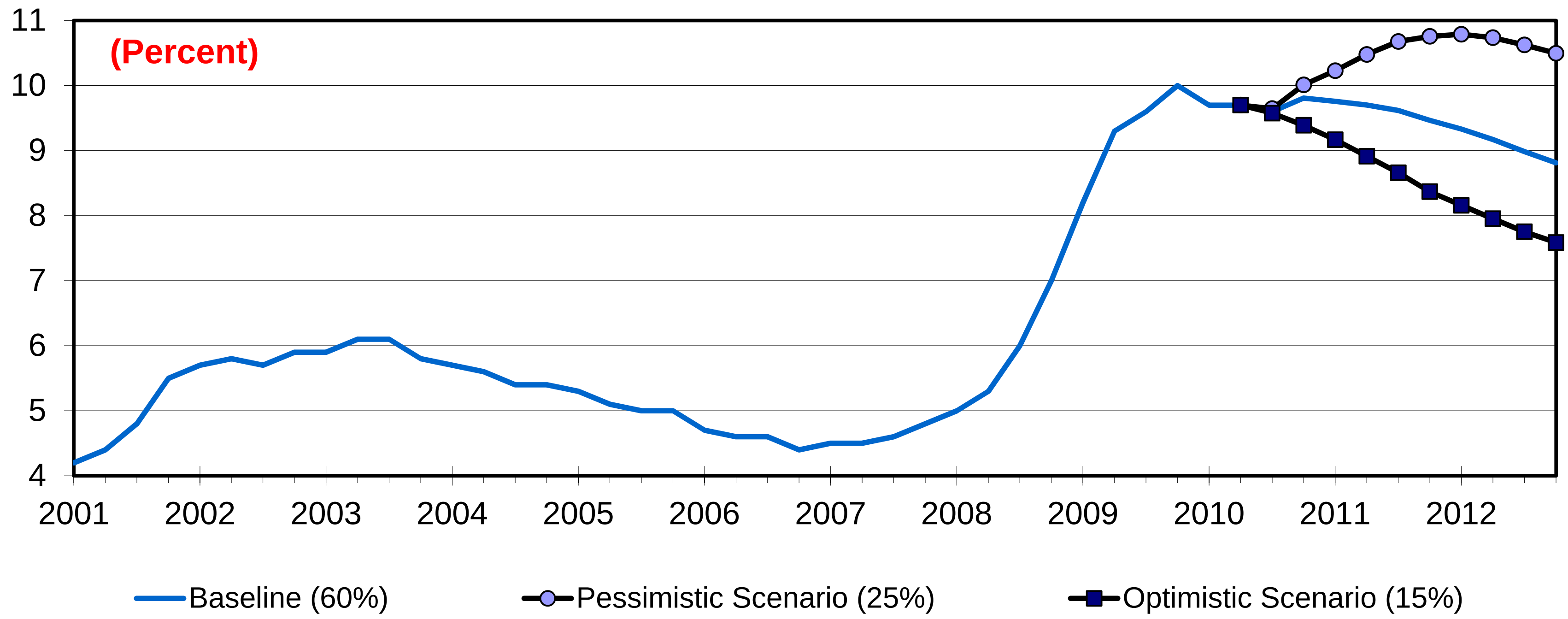
(Percentage Change From A Year Ago)




- Typically after recessions end, construction booms and powers a new expansion
- Because of the residential and commercial hangover, tight credit and foreclosures, the current recovery has not benefited from new construction activity
- Construction employment has yet to go positive

# Based on Global Insight's Current Forecast, the Unemployment Rate Is Expected To Drop -- How Quickly Depends On The Consumer

- Based on current job growth, Global Insight's standard forecast assumes the unemployment rate will continue to decline through the forecast period at a much slower rate than in previous recessions
- If consumers begin to engage, job growth could be stronger which will reduce the unemployment rate more quickly



# How Has Virginia Employment Fared?

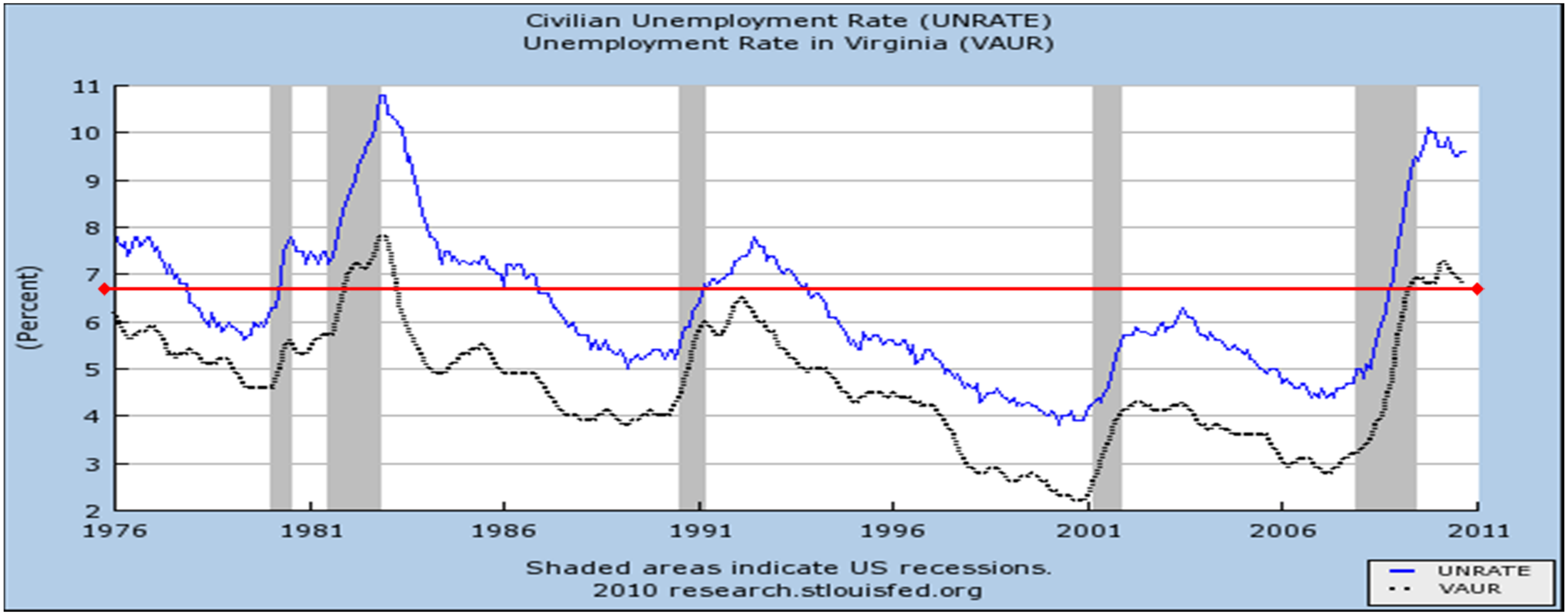
Again, Northern Virginia Leads Our Recovery

# Snapshot of Key State Employment Indicators

- Virginia's unemployment rate stands at 6.8% in September, down from 6.9% in August
  - In the year-over-year comparison (September 2009 to September 2010), nonfarm payroll employment is up 30,000 jobs
- Virginia continues to outpace the nation in terms of job recovery, having regained 41% of the total jobs lost since the trough in February 2010
  - Northern Virginia region has seen the most job growth, having recovered about half of its job loss
- Payroll employment in the Commonwealth grew 0.8 percent in September 2010 from September of last year – in line with the forecast for job growth
- The number of Virginians receiving a regular unemployment benefit payment was 61,088 in October 2010, down from 88,836 in February 2010 and down from 77,830 in October 2009
  - Initial claims for October 2010 totaled 36,561, compared to 43,958 the previous October, a decline of nearly 17%

# Virginia's Unemployment Rate in Perspective

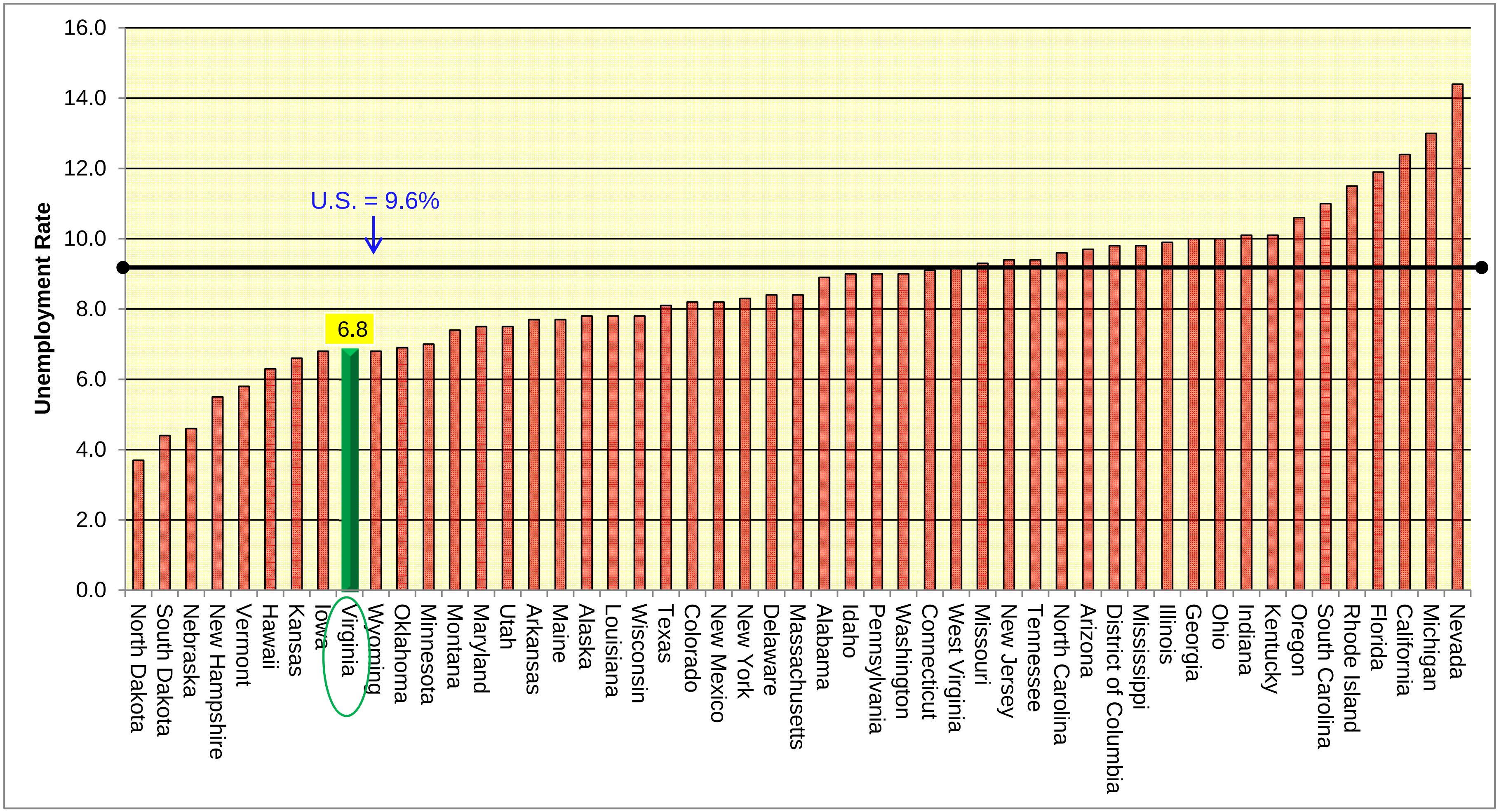
- While the national unemployment rate was consistent with the level of the 1982 recession - the worst in 30 years - Virginia's unemployment rate is closer to the 1991 recession rate
- Virginia's unemployment rate of 6.8% has been dropping since peaking at 7.3% in March of 2010 --- the nation's rate has ticked up slightly over the same period



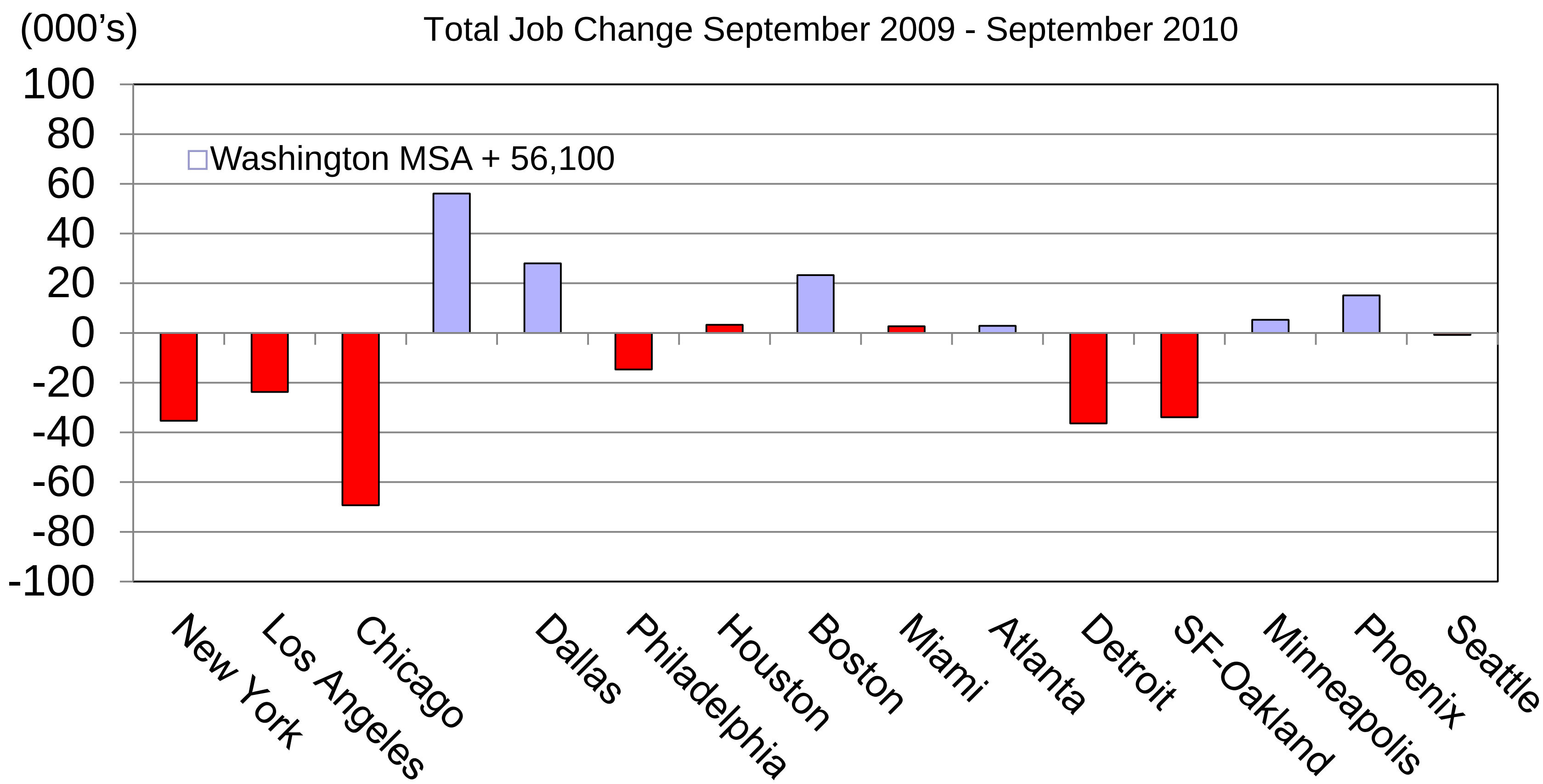
# Comparison of Virginia’s Employment Losses to Other States

- Virginia did not begin losing jobs until June 2008 -- 6 months after the recession began
- Virginia’s job losses were not as severe as other states
- Virginia’s unemployment rate is 8th lowest overall and 3rd among states over 1 million population
- Virginia is ranked 10th in terms of job growth for the September over September period
- Washington/Northern Virginia had the largest percentage job gains of any major MSA over 1 million workers
  - Hampton Roads is ranked 71
- Harrisonburg is ranked 6th among MSA’s of less than 1 million workers, Blacksburg is ranked 98

# Virginia's unemployment rate of 6.8% is the 8th lowest among all states, and 3rd lowest among states with over 1 million in population



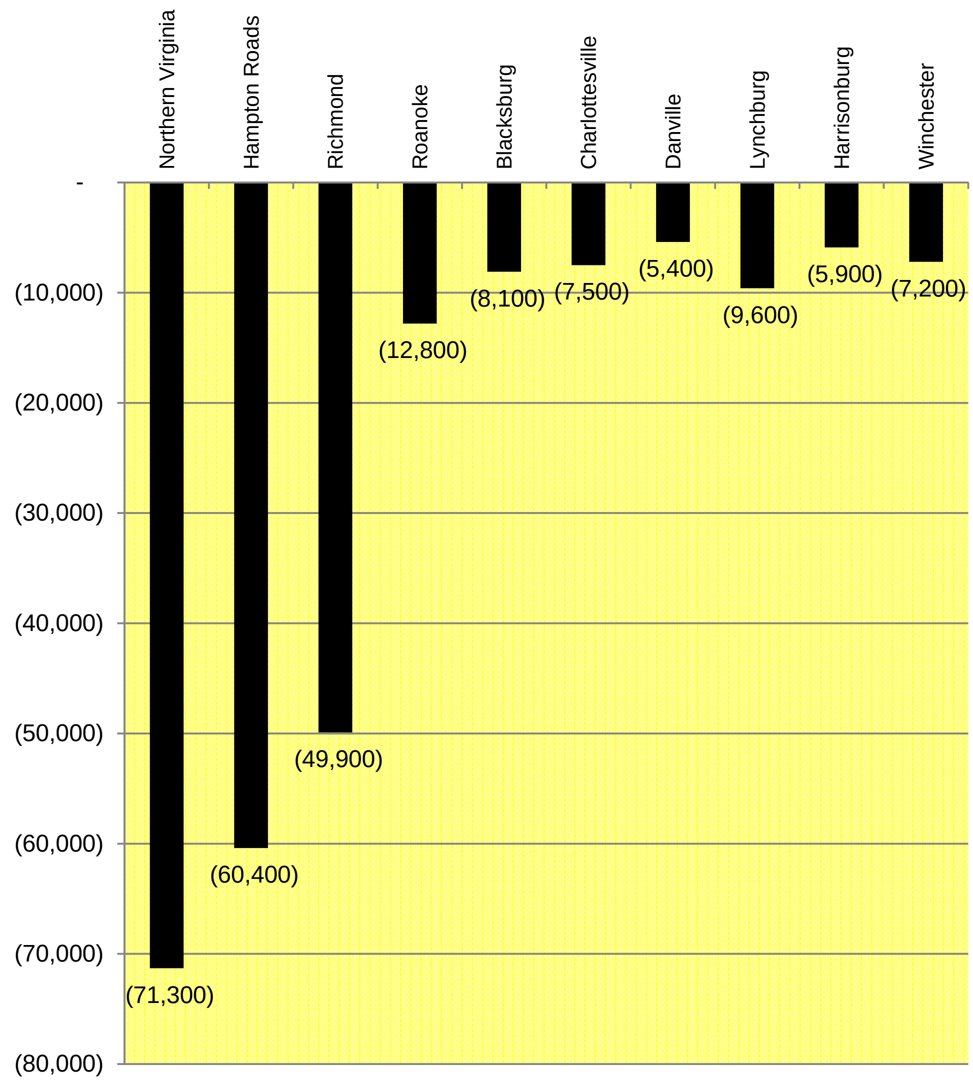
# Northern Virginia/Washington MSA Had the Largest Percentage Job Gain of Any Major Metropolitan Area at 1.92%



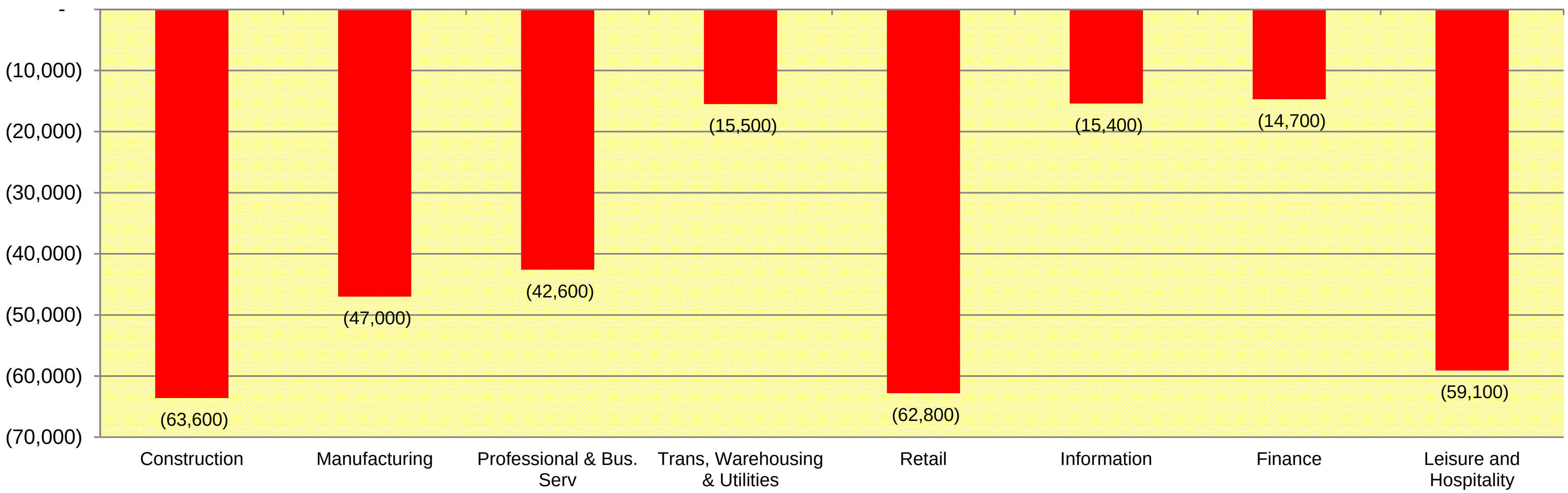

Source: BLS data, Seidman Research Institute, W.P. Carey School of Business, Arizona State University

# Peak To Trough Virginia's Job Loss Totaled 273,100
# How Did Each Region Fare?

- Virginia's job loss lagged the nation by 6 months
  - Nationally employment peaked in December 2007, compared to June 2008 for Virginia
- In total, Virginia lost 273,100 jobs from peak to trough
  - Job loss was experienced in all regions of the state
- Northern Virginia experienced less job loss than any other region relative to their percentage of total employment
  - NoVa accounted for 26% of the state's total job loss, but represents 36% of the state's total employment
- Richmond and Hampton Roads represent 37% of the state's employment and accounted for 40% of total declines
- The balance of the state represents 28% of total employment, but experienced nearly 36% of the state's job loss
  - Reflects heavy losses in manufacturing

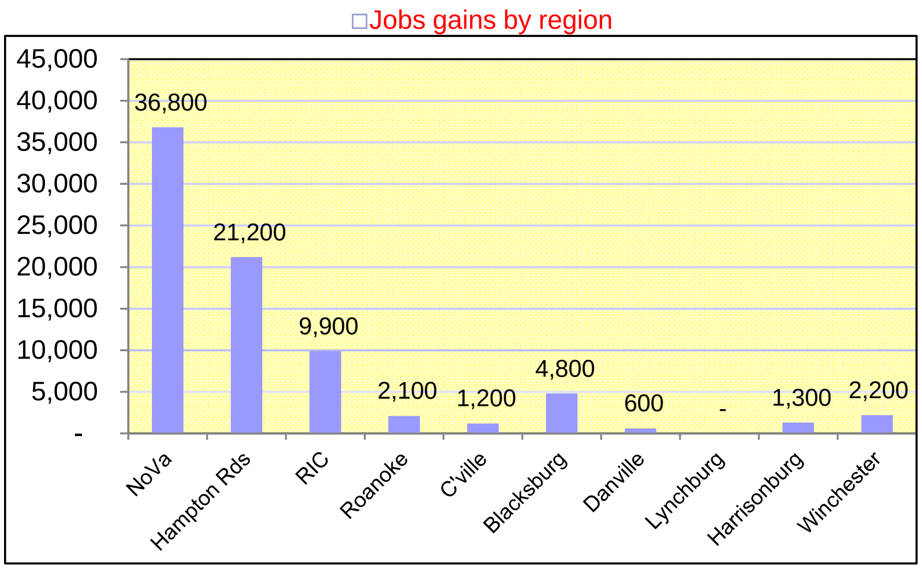


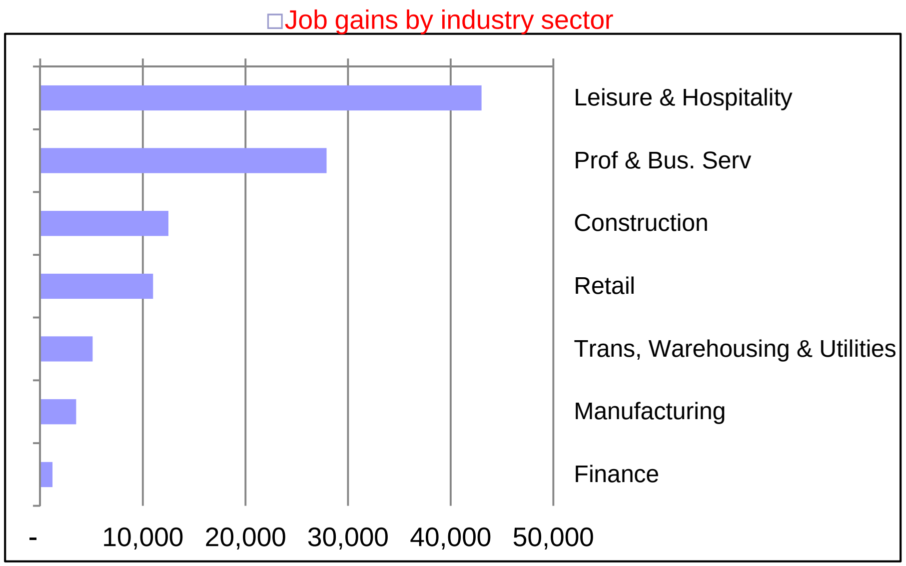
# Job Loss By Employment Sector




- In <u>proportion</u> to the state's total employment, construction and manufacturing employment was the hardest hit
- Education and Health Services and federal employment <u>did not</u> see any job losses and represent 20% of the total workforce
- Job losses in local government employment lagged nearly 12 months after the declines seen in the broader employment sectors

# Since The Trough, Virginia has Recovered 111,600 Jobs – 41% The Total Job Loss




- Virginia began recovering jobs in February 2010 (trough)
- Lynchburg is the only MSA yet to begin recovering from its job loss
- Northern Virginia has recovered 52% of their job losses
- Job gains have been primarily concentrated in Business and Professional Services and Leisure and Hospitality sectors

# Virginia's Employment Outlook

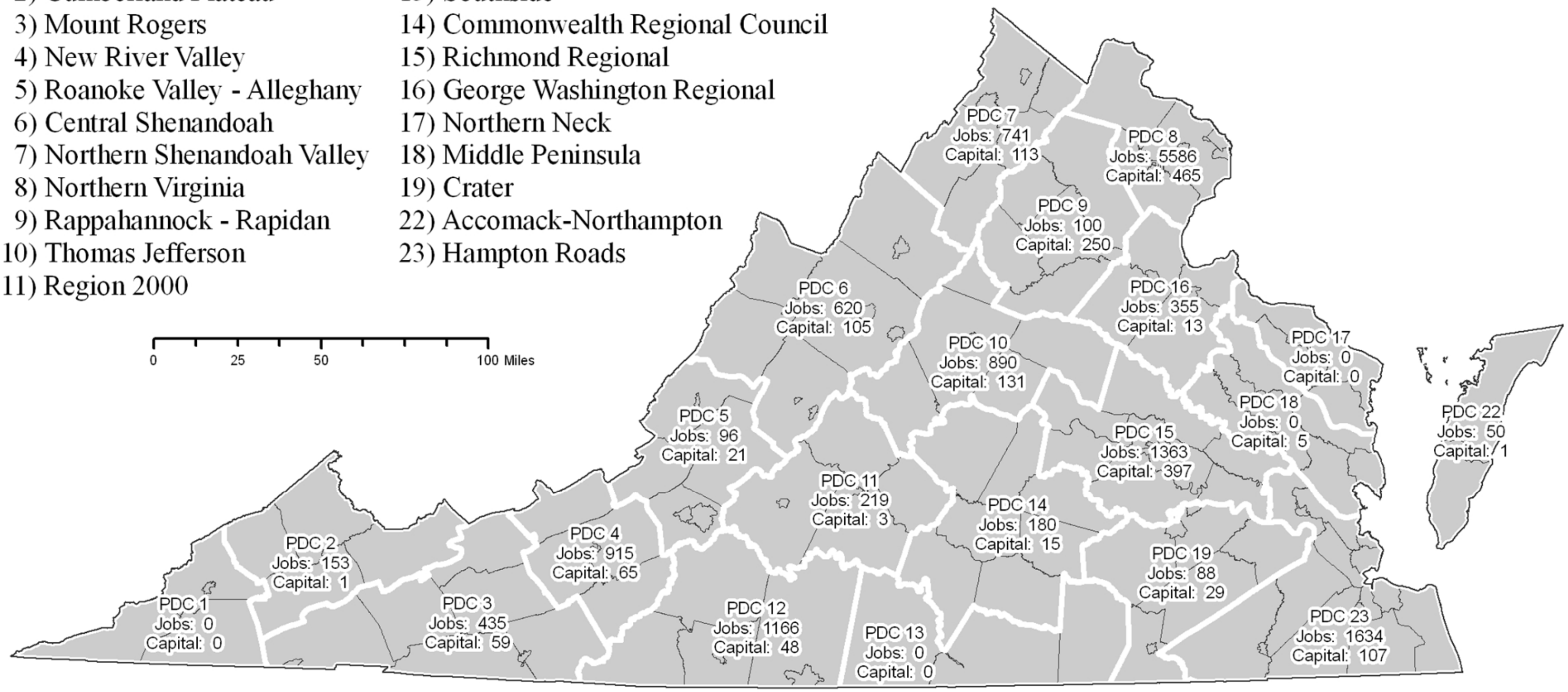
- Virginia is expected to out-perform the nation in employment growth, however, job growth is expected to perform slightly below trend line growth of 2.1%. This is due in part to several factors:
  - We have not shed as many jobs as other states
  - We have a low unemployment rate relative to other states
  - Professional and Business Services represent nearly 18% of total employment, and has not suffered the same rate of job loss
  - Virginia's manufacturing employment is less than 7% of our total jobs compared to 10% for the nation. As the economy improves, manufacturing employment typically experiences stronger job growth
  - Construction employment will be slow to recover because of the lack of demand in housing and commercial building
- Northern Virginia is expected to continue leading the recovery
- Virginia continues to attract new companies, along with some expansions of existing companies
  - Likewise, many companies are recalling employees

# Employment Creation and Capital Investment by Planning District
## Fiscal Year 2010

16,400 New Jobs Announced by VEDP in FY 2010

**Planning District Commission (PDC) Name & Number**

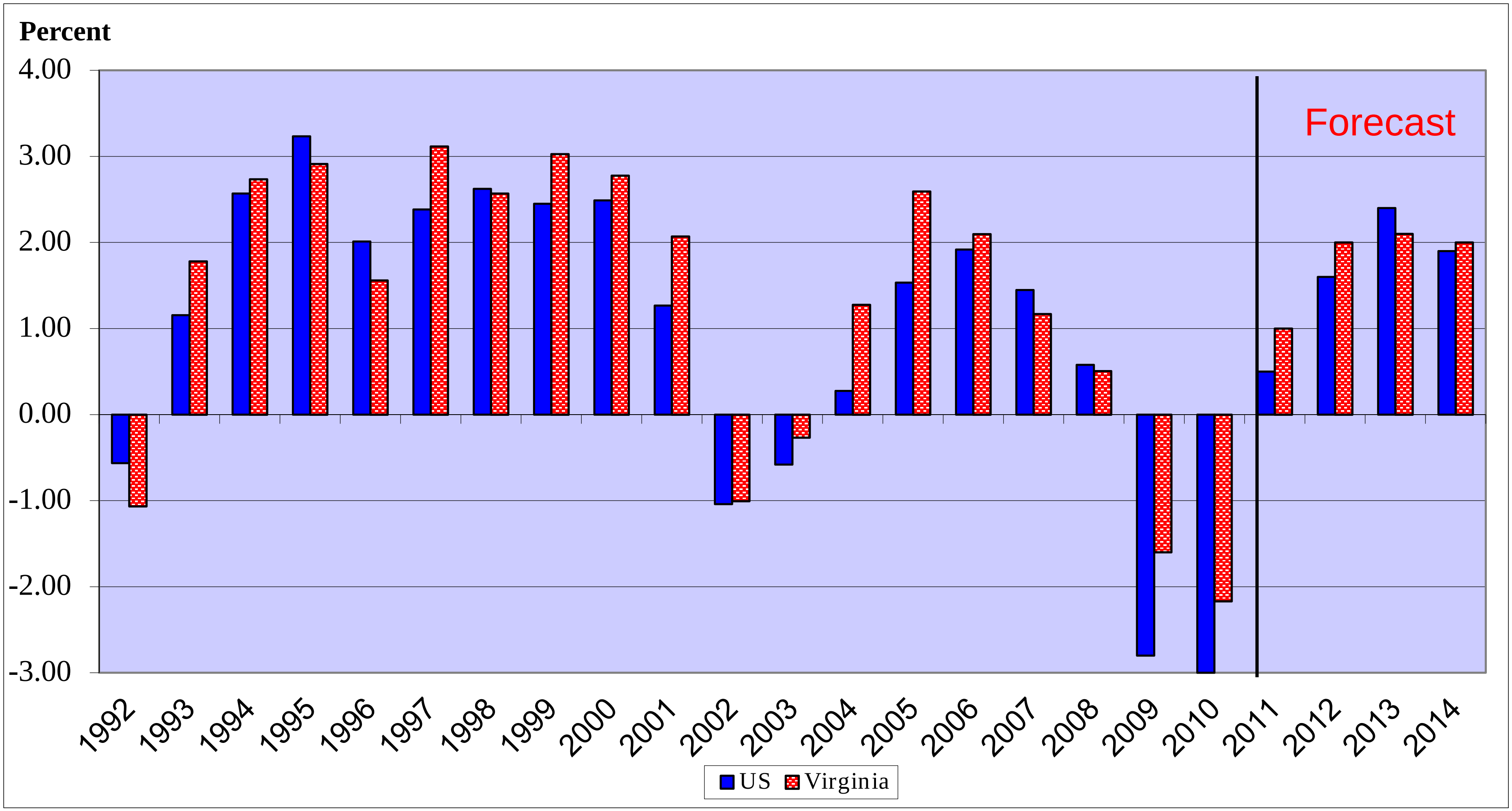
1) Lenowisco
2) Cumberland Plateau
3) Mount Rogers
4) New River Valley
5) Roanoke Valley - Alleghany
6) Central Shenandoah
7) Northern Shenandoah Valley
8) Northern Virginia
9) Rappahannock - Rapidan
10) Thomas Jefferson
11) Region 2000
12) West Piedmont
13) Southside
14) Commonwealth Regional Council
15) Richmond Regional
16) George Washington Regional
17) Northern Neck
18) Middle Peninsula
19) Crater
22) Accomack-Northampton
23) Hampton Roads




*Numbers on map indicate jobs created and capital invested in millions for FY2010. All announcements are subject to revision.*

*Map created by Virginia Economic Development Partnership, September 2010*

# US and Virginia Employment Growth
## FY 1992-10 Actual and FY 2011-14 Forecast
## Annual Percent Change



# Update on Consumer Spending and Housing Market

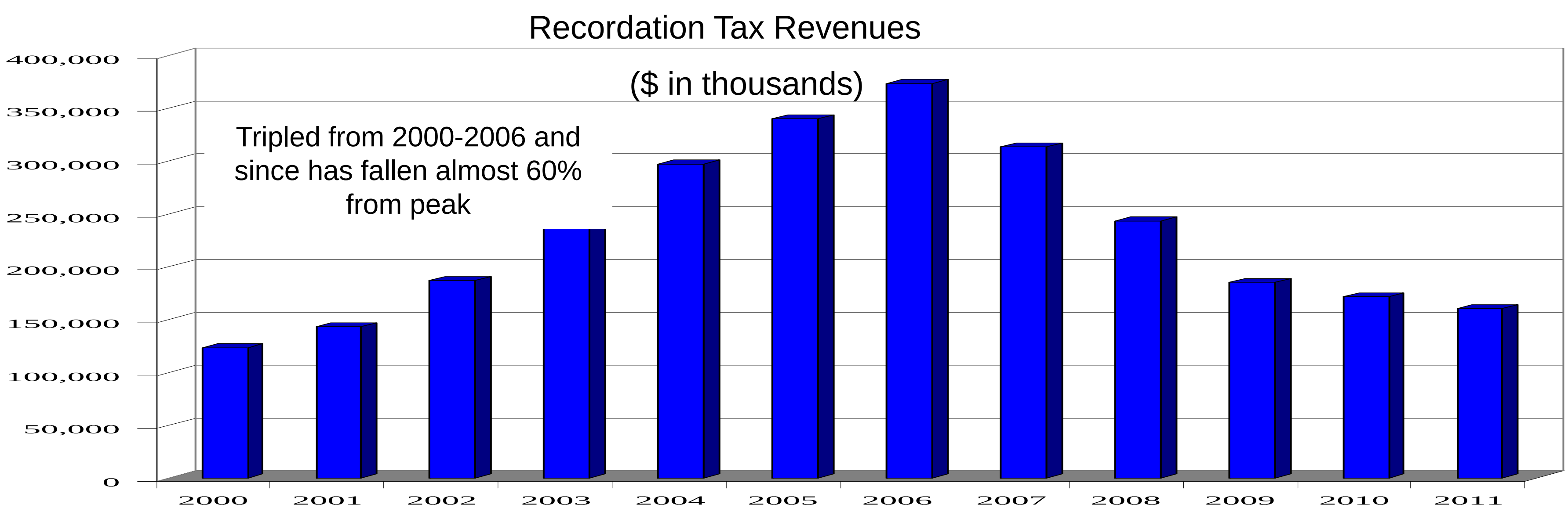
# Housing

# A Housing Downturn of Historic Proportions

- For 4 straight years we've heard that housing will hit bottom and begin to recover next year
- Since peaking in the third quarter of CY 2005, home sale volumes in Virginia and across the nation fell to levels not seen in more than a decade, housing starts remain at post WW-II lows and foreclosures continue to increase in some regions
- The Bureau of Economic Analysis's 3rd quarter 2010 report on GDP shows that residential investment as a percent of GDP has declined to a post-war low of 2.22%
- This is especially telling in that residential investment generally accounts for a large percentage of the employment and GDP growth in the first year or so of a recovery. Not this time.
- The unprecedented housing freefall has impacted general fund revenue sources, in particular recordation and sales tax

# Recordation Taxes – Continued Weakness

- Recordation taxes were a minor general fund revenue source prior to FY 2000
  - In FY 2000, they comprised only 1.1% of GF revenues -- $123 million
- Over the next 6 years, recordation tax collections (exclusive of tax increase) grew 3-fold
  - From FY 2001 through FY 2006, recordation tax receipts grew an average of 21% annually
- Inclusive of the tax increase, recordation revenues totaled $622.5 million and comprised almost 5% of GF revenues in FY 2006. They now have fallen back to 2.2% of revenues
- Recordation fell precipitously for 3-years and continues to decline, albeit at slower rates
  - FY 2011 revenue forecast assumed growth of 8.2% but through October, collections were down 4.0% - based on year-to-date trends, we are likely to see a downward revision when budget amendments are introduced



# Impact of Housing Decline on Sales Tax Collections

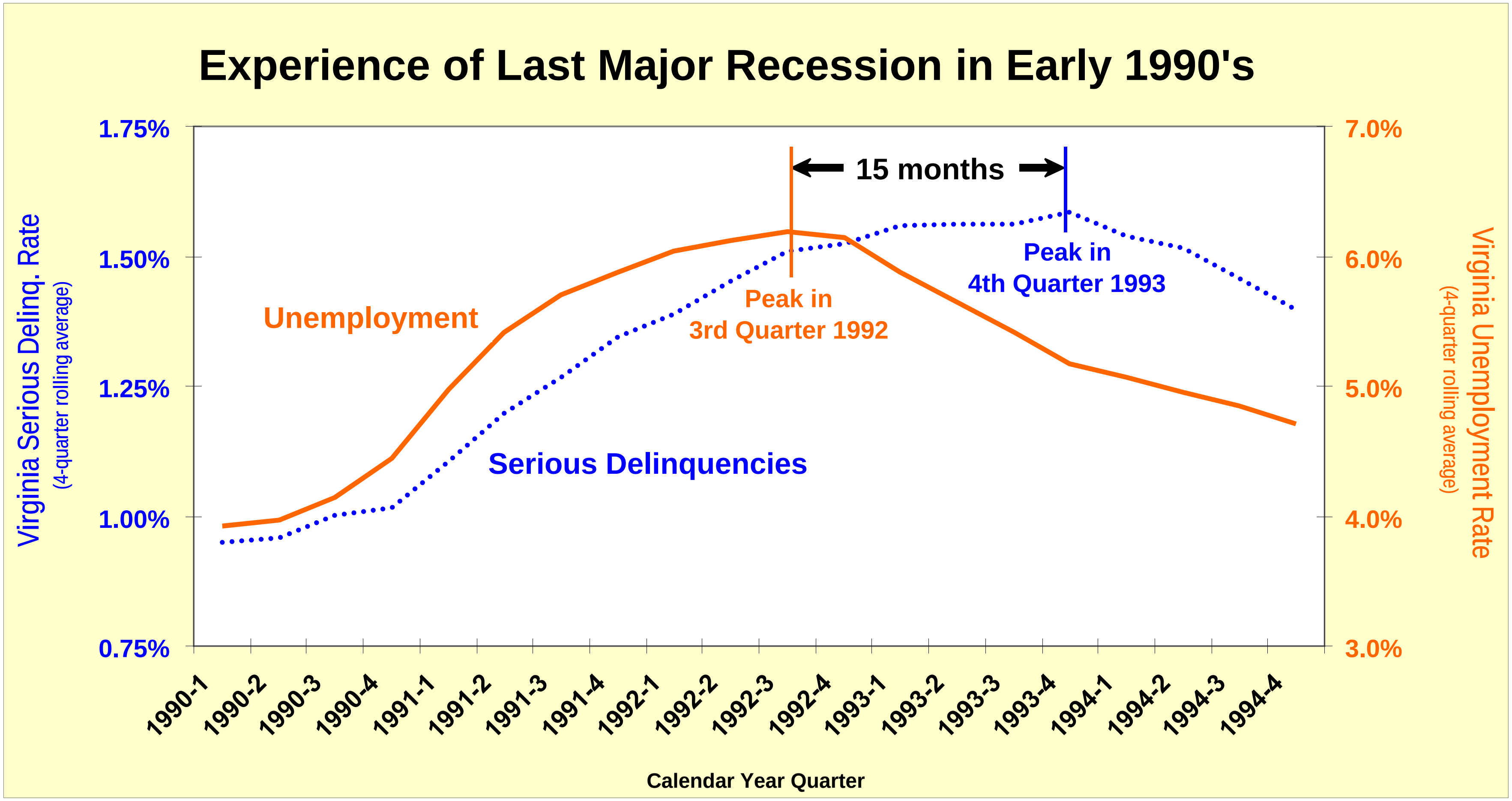
| Large Sales Tax Payments | | | | | |
|---|---|---|---|---|---|
| Peak to Trough by Sector | | | | | |
| | | | | | |
| | | Millions of dollars | | % of Total | |
| Sector | # of Firms | 06Q2 | 10Q1 | 06Q2 | 10Q1 |
| Housing | 173 | $130.9 | $84.6 | 25% | 17% |
| Warehouse Clubs/Supercenters | 6 | 83.5 | 98.0 | 16% | 19% |
| Department Stores | 113 | 85.2 | 94.4 | 16% | 19% |
| Grocery Stores | 20 | 63.9 | 78.3 | 12% | 15% |
| Retail Trade | 98 | 51.7 | 66.7 | 10% | 13% |
| Restaurants | 76 | 29.5 | 28.7 | 6% | 6% |
| Wholesale Trade | 73 | 17.5 | 11.0 | 3% | 2% |
| Gasoline Stations | 17 | 12.7 | 10.7 | 2% | 2% |
| Other | 336 | 54.3 | 34.7 | 10% | 7% |
| | | | | | |
| **Total** | **912** | **$529.2** | **$507.1** | 100% | 100% |

On a dollar basis, sales tax collections from large housing-related companies fell 35% from peak to trough

# The Foreclosure Story

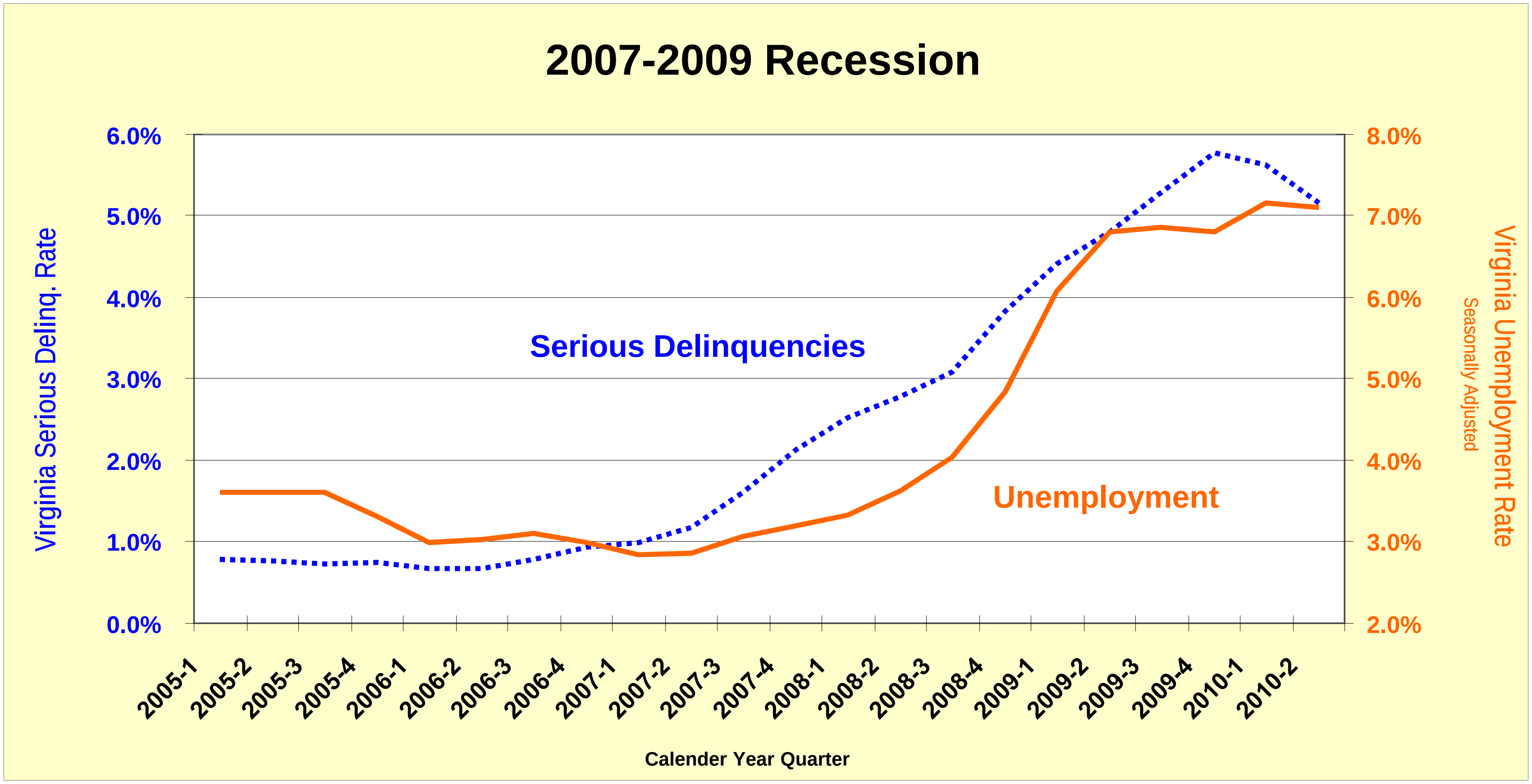
- What factors have made this housing downturn more protracted than those associated with typical recessionary periods?
  - One primary difference was that the housing bubble was driven by increases in homeownership rates that simply were not sustainable
    - Expanded home ownership driven by the proliferation of subprime and other nonconventional/no documentation loans
    - This led to a supply crunch which then drove rapid price appreciation and overly optimistic building
  - In contrast to most recessions, the collapse of the credit and housing markets and high increases in foreclosures marked the <u>start</u> of the recession
  - Typically foreclosures are a lagging indicator, increasing <u>after</u> declines in employment
    - What this has meant is we have seen two waves of foreclosures

# In the 1991 Recession the Peak in Defaults Was A Lagging Indicator



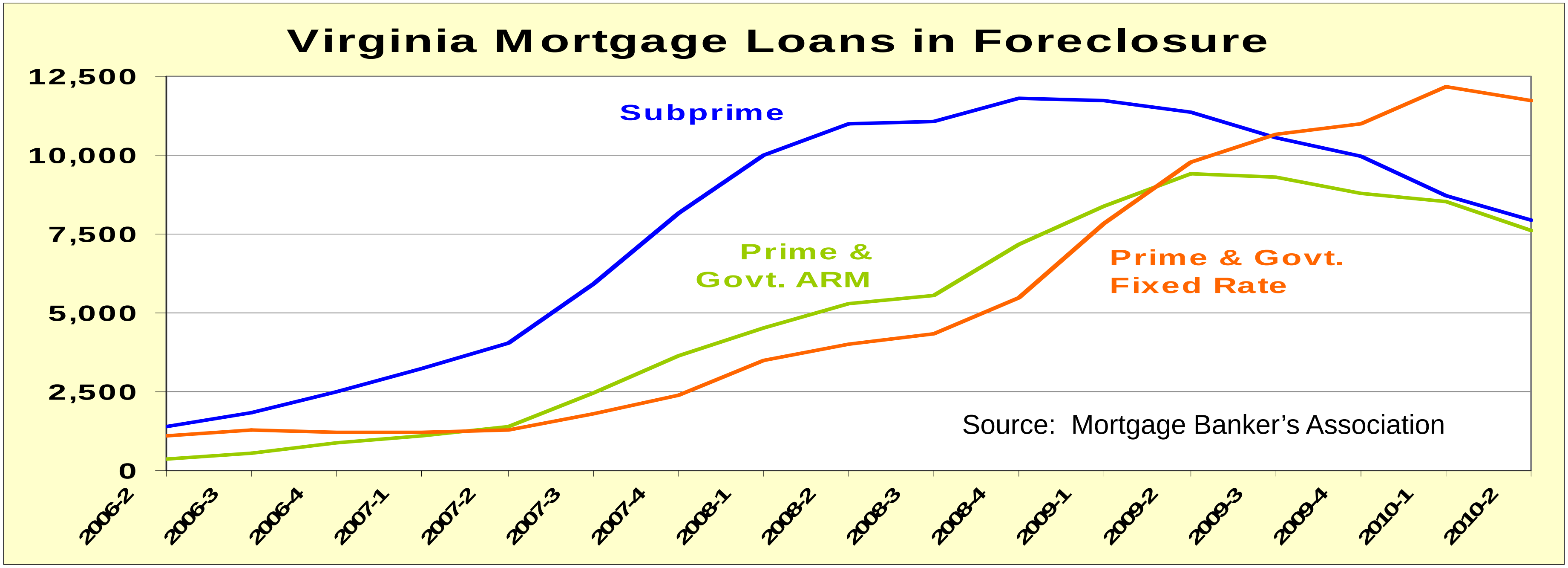

Source: Virginia Employment Commission and Mortgage Bankers Association (MBA)

# This Time, Defaults Have Been a Leading Rather than a Lagging Indicator




Source: Virginia Employment Commission and Mortgage Bankers Association (MBA)

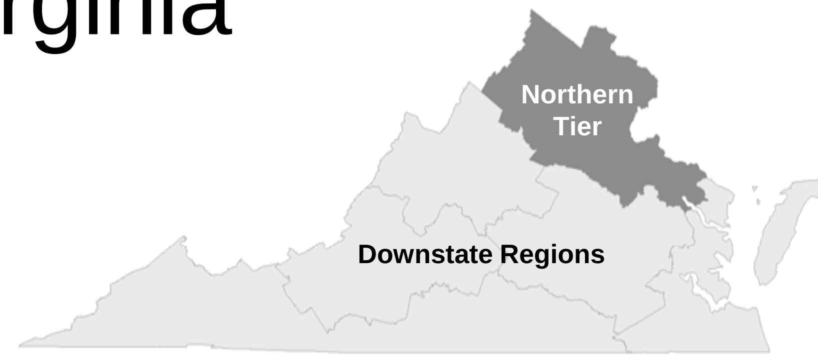
# Subprime Foreclosures are Declining as Prime Foreclosures Begin to Peak

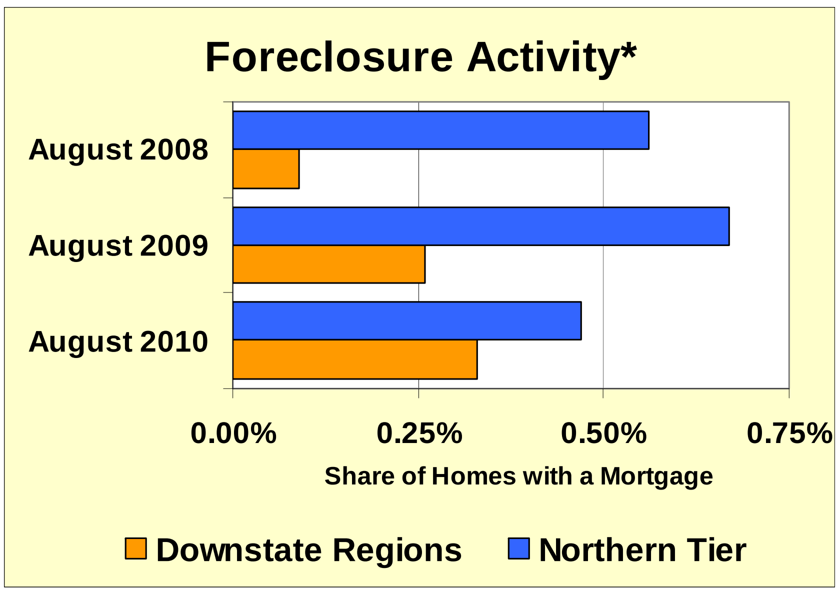



- The foreclosure crisis began with massive defaults on riskier sub-prime and low/no documentation loans
  - In Q2 2008, 54% of all Virginia foreclosures were associated with subprime and Alt-A loans
- Recession-driven job and income losses are now forcing homeowners with conventional mortgages into default — especially if they are "underwater" and cannot sell
  - By Q1 2010, subprime and Alt-A loans had fallen to 29% of the total, and prime and government fixed rate loans now make up 43% of Virginia foreclosures

# Virginia's Foreclosure Crisis Began in Northern Virginia

- In mid 2008, Virginia foreclosure activity was heavily concentrated in Northern Virginia

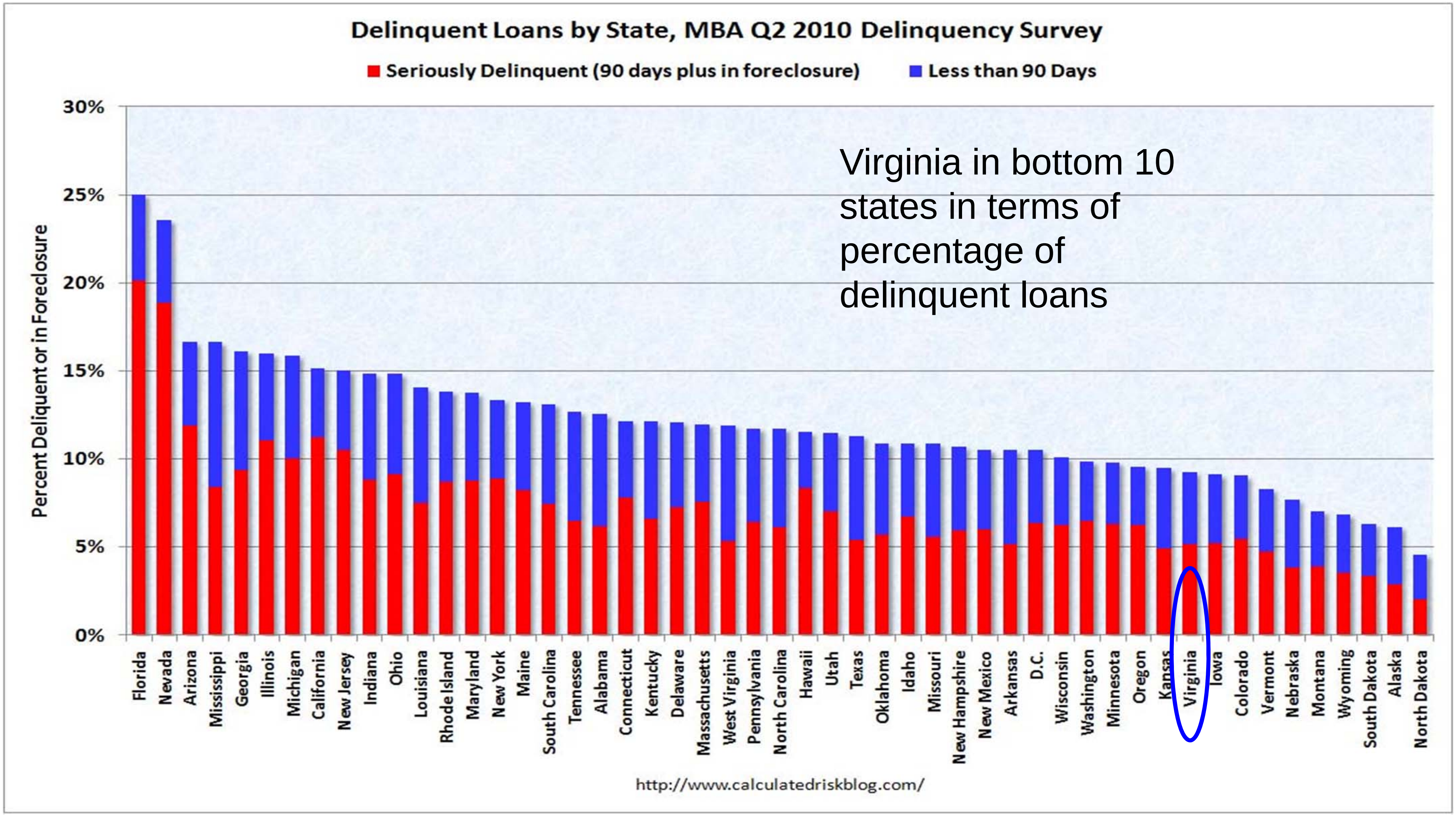



- Highest price appreciation in that region led to greatest price drops when bottom dropped out of market
  - Northern Virginia saw price declines in excess of 30% peak to trough
- Foreclosure situation has improved statewide with a year-over-year reduction in foreclosures of 5.5% through October
  - This decrease is driven entirely by a reduction in foreclosures of 28% in the core of Northern Virginia

Source: RealtyTrac and Census Bureau

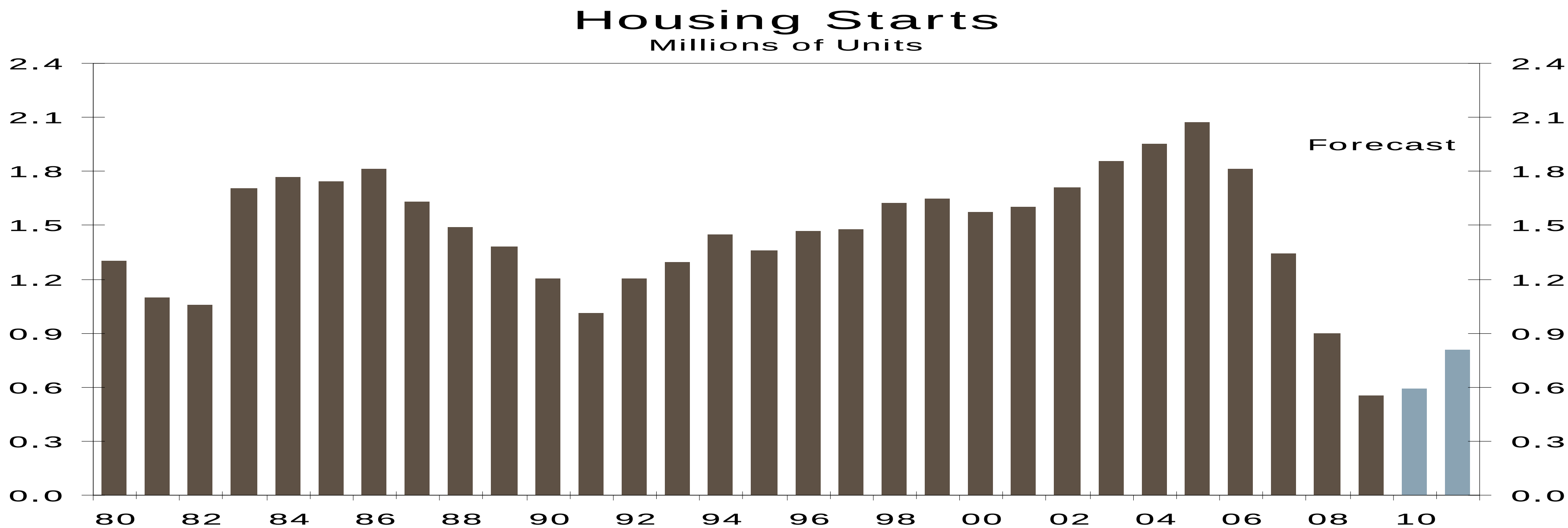
# Virginia Has Fared Comparatively Well




Source: Mortgage Bankers Association (MBA)

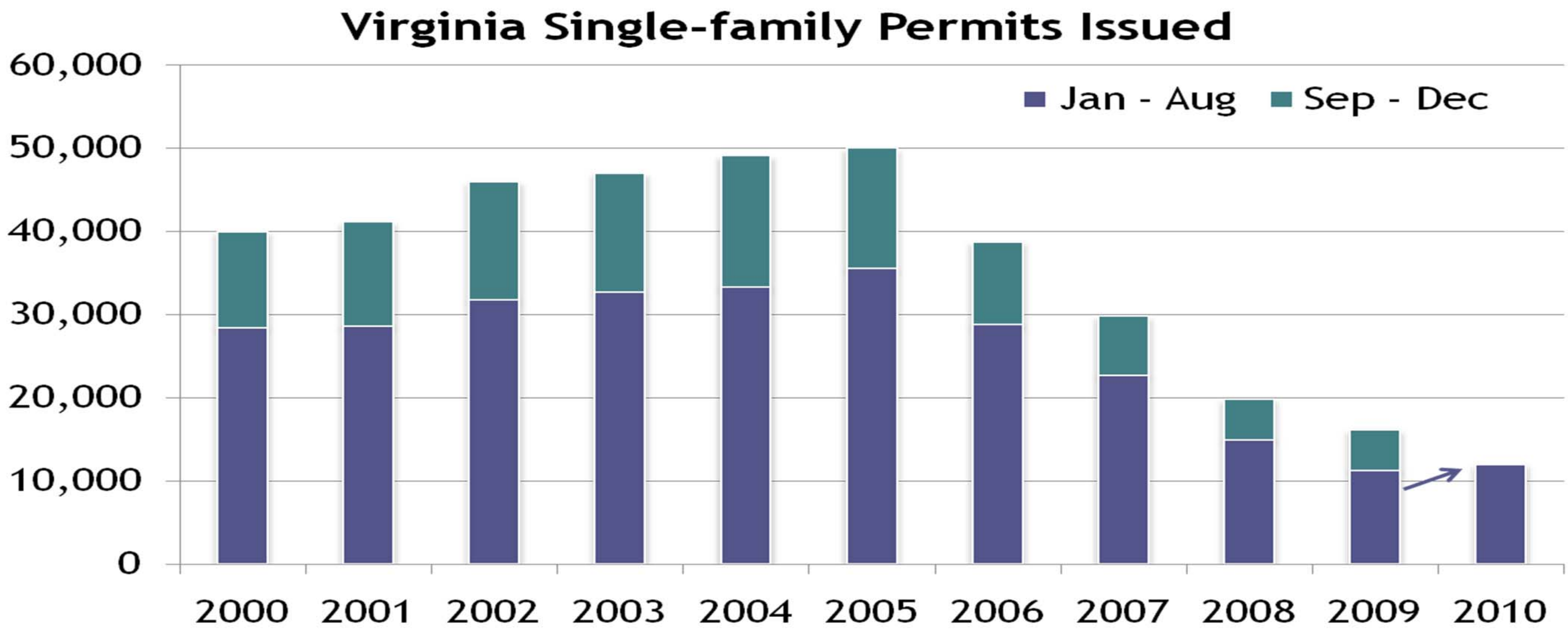
# Have We Finally Reached Bottom?

# National Homebuilding Trends



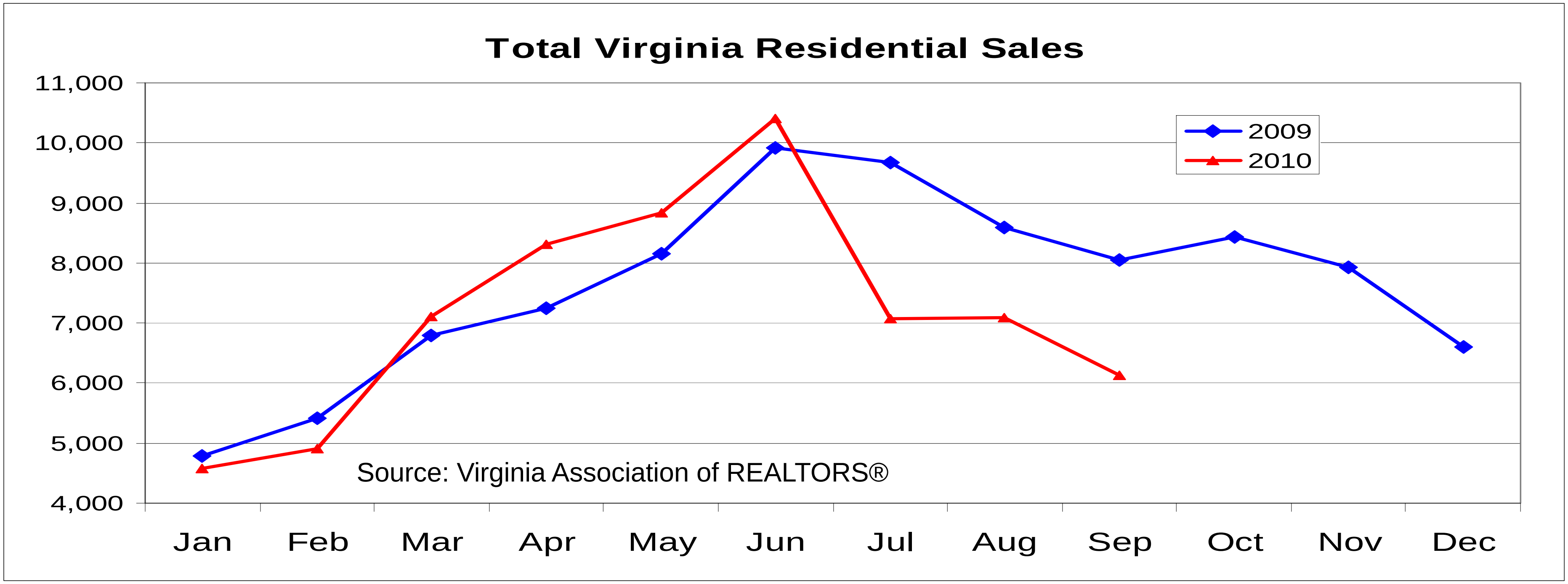

- US Bureau of Census data on housing starts show they reached a bottom in 2009 and have shown marginal improvement in the current year
- Forecasts project modest growth in the next calendar year, but starts will remain at levels below the even the slump at in the early 1980s

# VA Single-family Permits Show Similar Trends



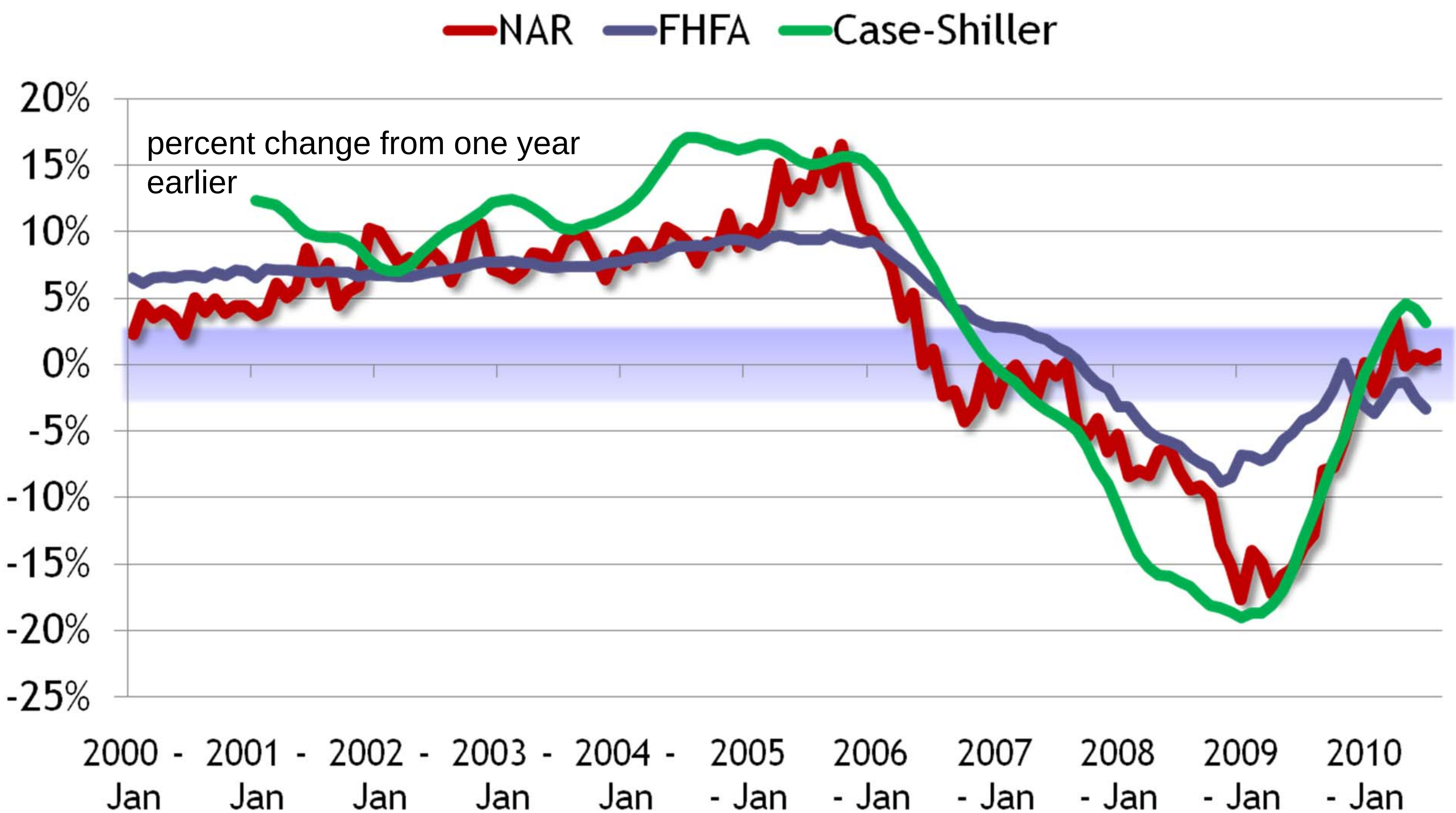

- US Bureau of Census data show similar trends in Virginia
- Through August, permits were up 6.3% from 2009 levels, but still will be well below 50% of housing starts we saw in 2000

# Home Sales In Virginia Lagging Since Homebuyer Tax Credit Expired



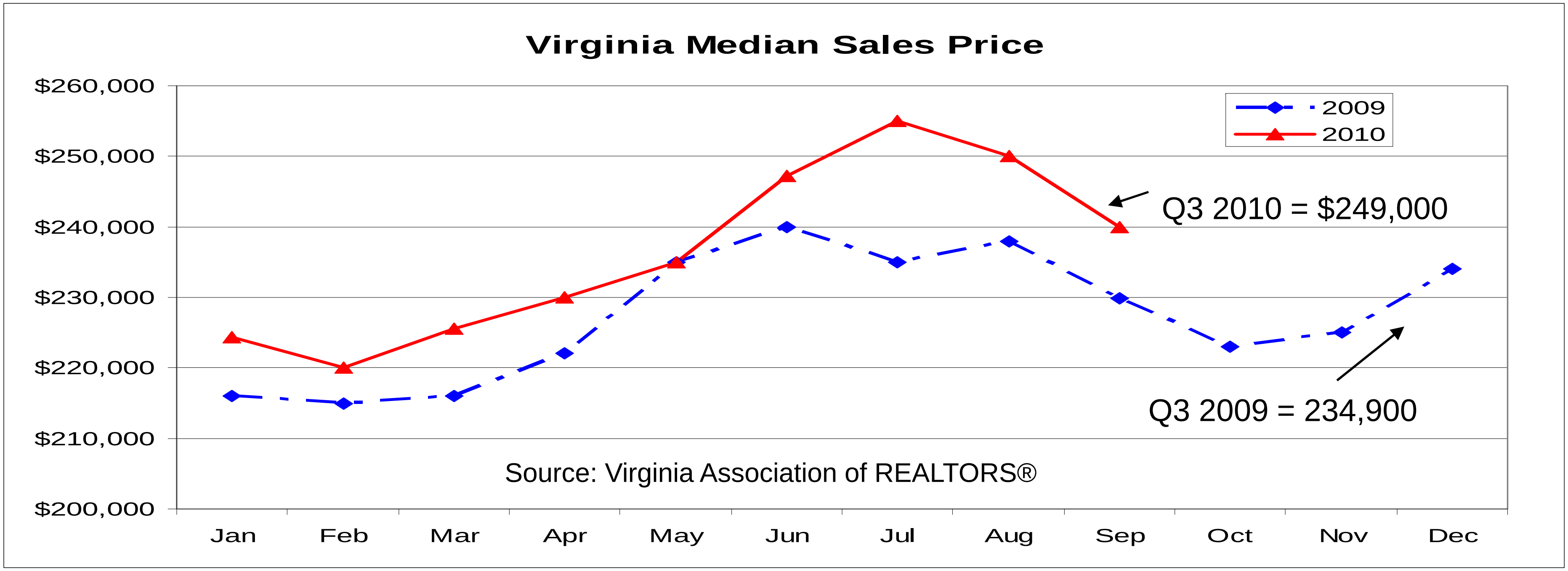

- After increasing 4% for the first six months of the current year, Virginia home sales have fallen to 6% below 2009 levels through the 3rd quarter of 2010
  - 3rd quarter sales were a disappointing 22% below 2009 levels
- The home buyer tax credit appears to have sped up sales that would have occurred later in the year, but used up most of the current demand

# Nationally Home Prices Moving Toward Stability



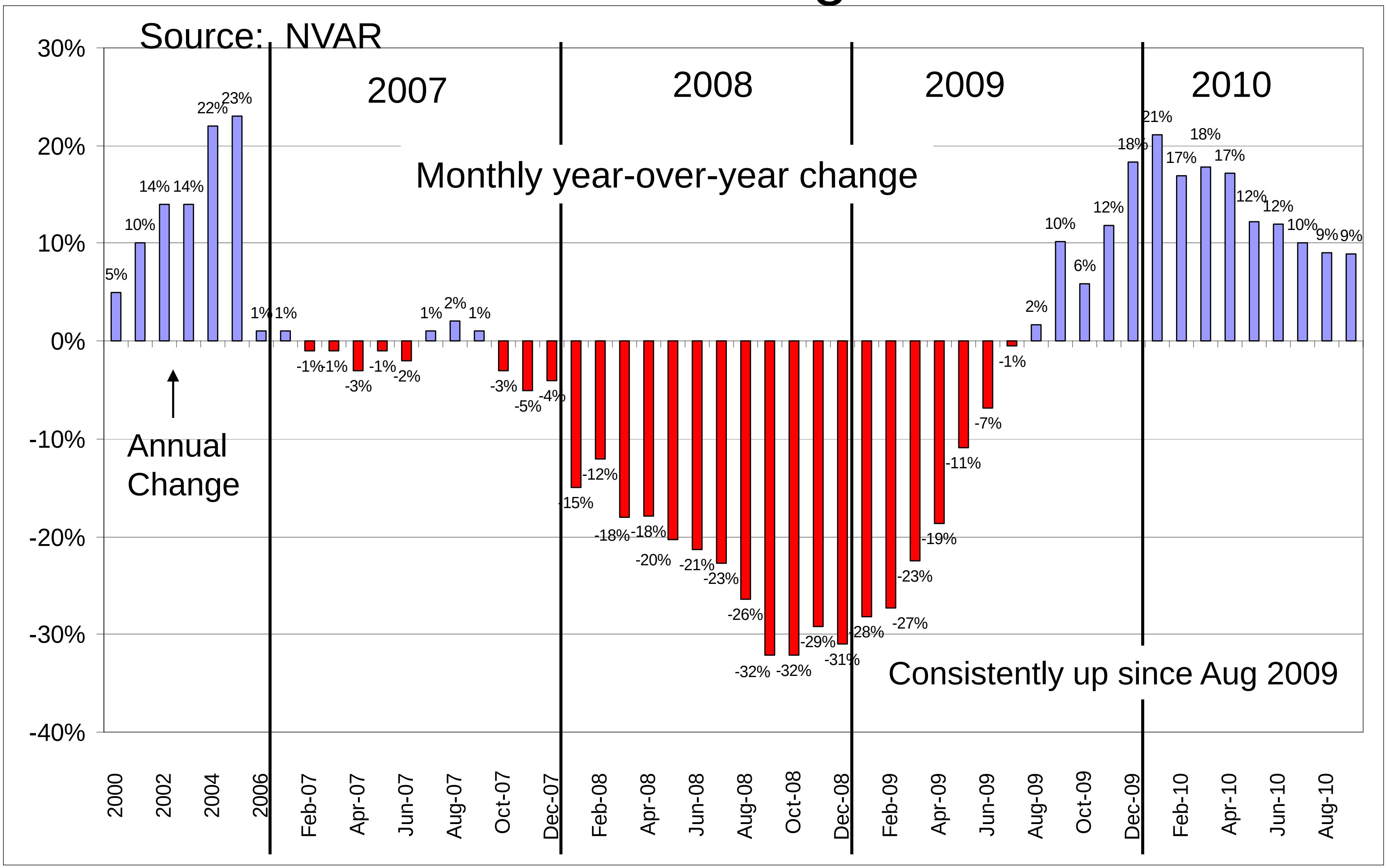

Source: National Association of Realtors

# Virginia Home Prices Higher in 2010




- While sales are down, median sales prices are showing a 6% increase compared to the 3rd quarter of 2009 and have been consistently up this year
- Homes selling for over $300,000 have shown growth for two years, while declines continue in the $100-200,000 range
- Year to date, median sales prices have increased in 4 of 7 regions of the Commonwealth – Richmond, Hampton Roads, Northern Virginia and the greater Roanoke/Lynchburg/Blacksburg region

# Average Sales Price Change – Greater Northern Virginia



# Factors Influencing the Housing Recovery

<u>Constraints:</u>

- Homeowners “underwater” – negative amortization
- Burn off of foreclosure stock
- High Inventory
  - Potentially large shadow inventory as well, as homeowners remain in houses because of low sales prices

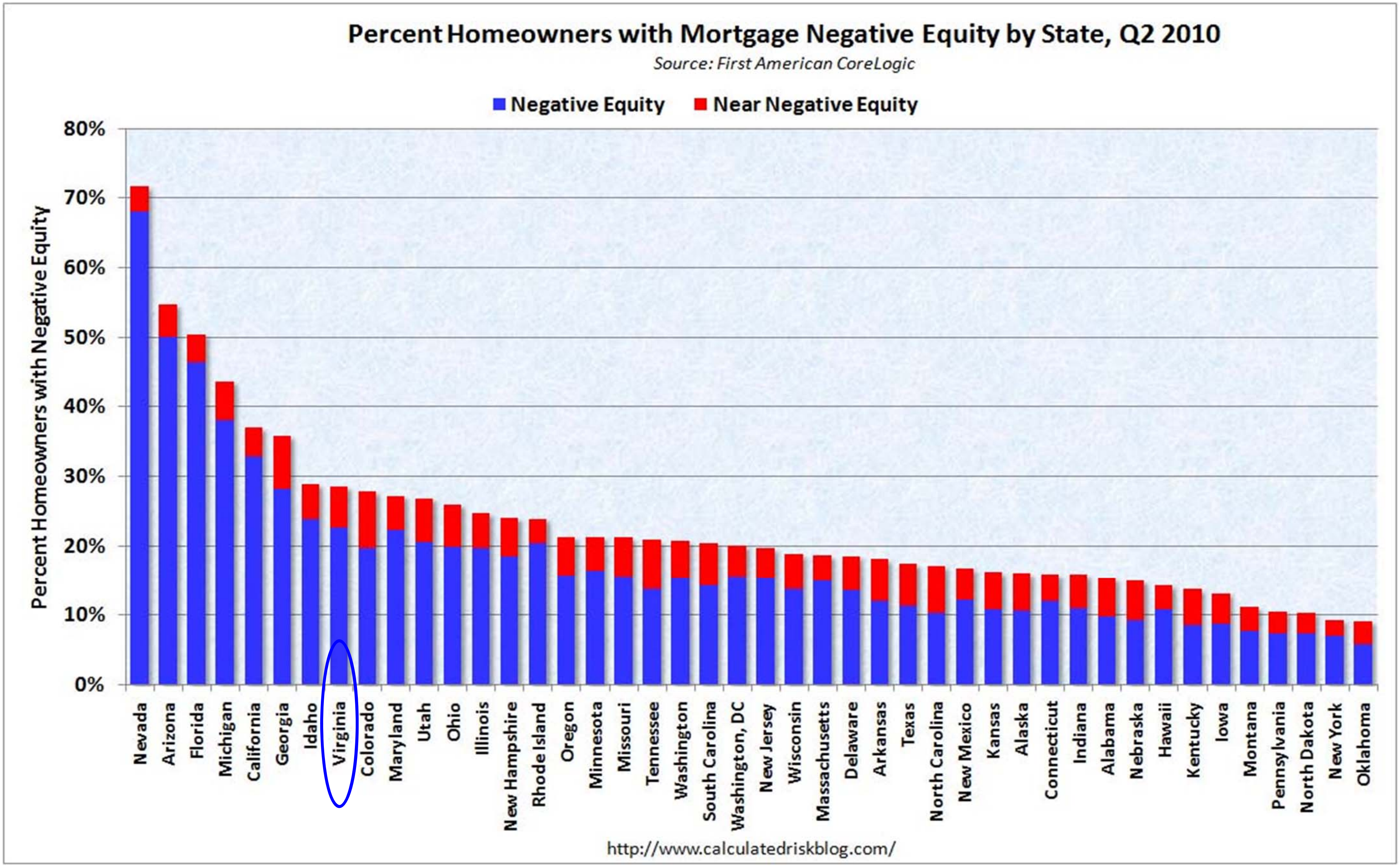
<u>Positive Forces:</u>

- Affordability has improved dramatically, especially in major markets
- Mortgage rates continue to track all-time lows
- Low level of housing starts points to long-term stabilization of supply

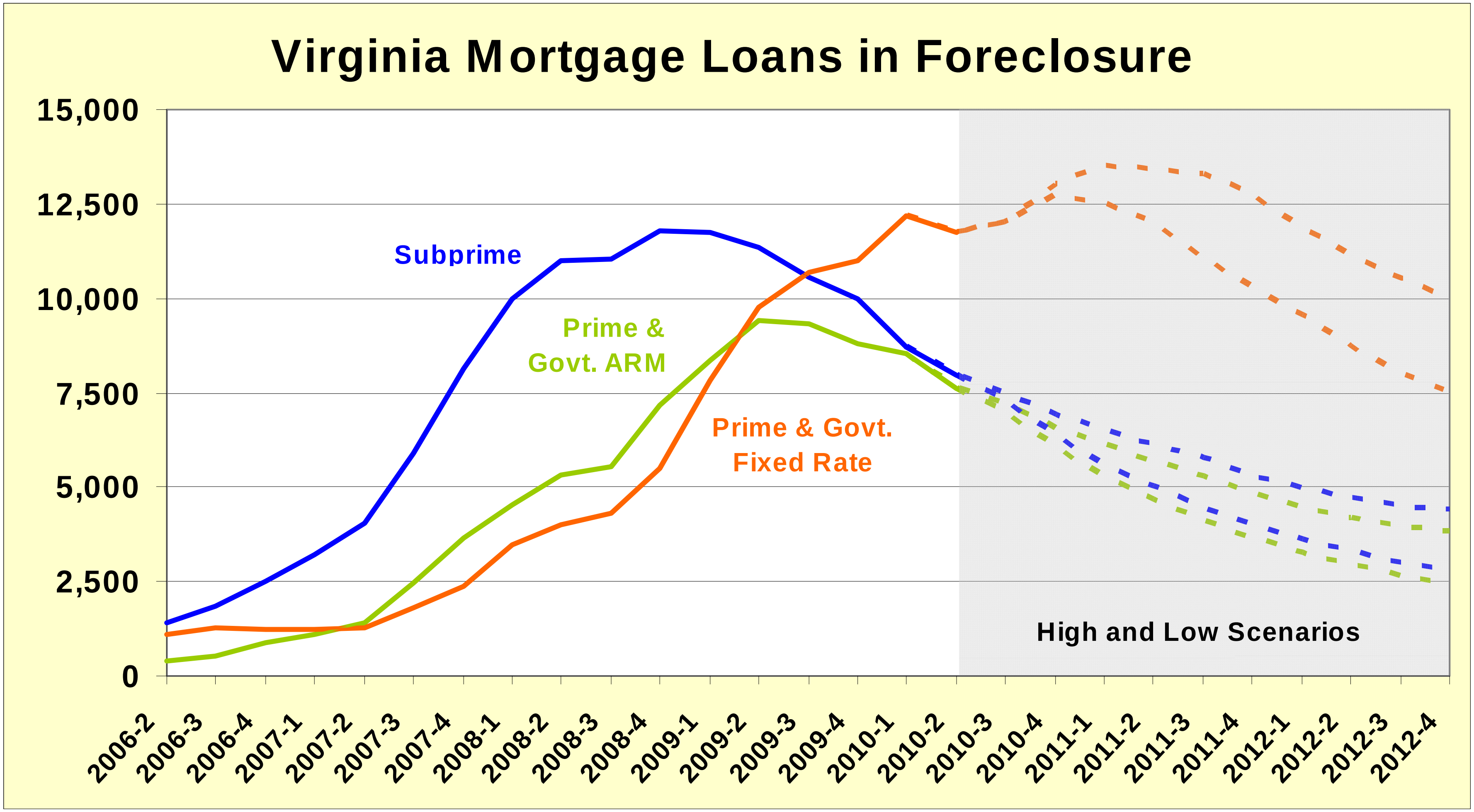
# Homeowners in Negative Equity

- Nationally, 30.6% of homeowners with mortgages are in negative equity
  - Inclusive of those who own their homes out right, this translates to about 18.5% of all homeowners in the nation
- The FDIC estimates $2.4 trillion in mortgage debt in negative equity as of the first quarter of 2010
- However, the rates continue to be driven by huge levels of price drops in a few key states – Nevada, Arizona, Michigan, Florida and California
  - In Nevada, close to 70% of all homeowners with mortgages are in negative equity – they have seen price declines averaging 58% since the peak
- While Virginia is among the top 10 states in terms of negative equity, the problem is nowhere as broad or as severe – the huge price increases in Northern Virginia drove the issue
  - And as we have seen, this is one region where pricing is clearly rebounding

# “Underwater” Homeowners Hinder Stabilization



# Fixed Rate Loan Foreclosures Are Likely to Remain High Through 2012



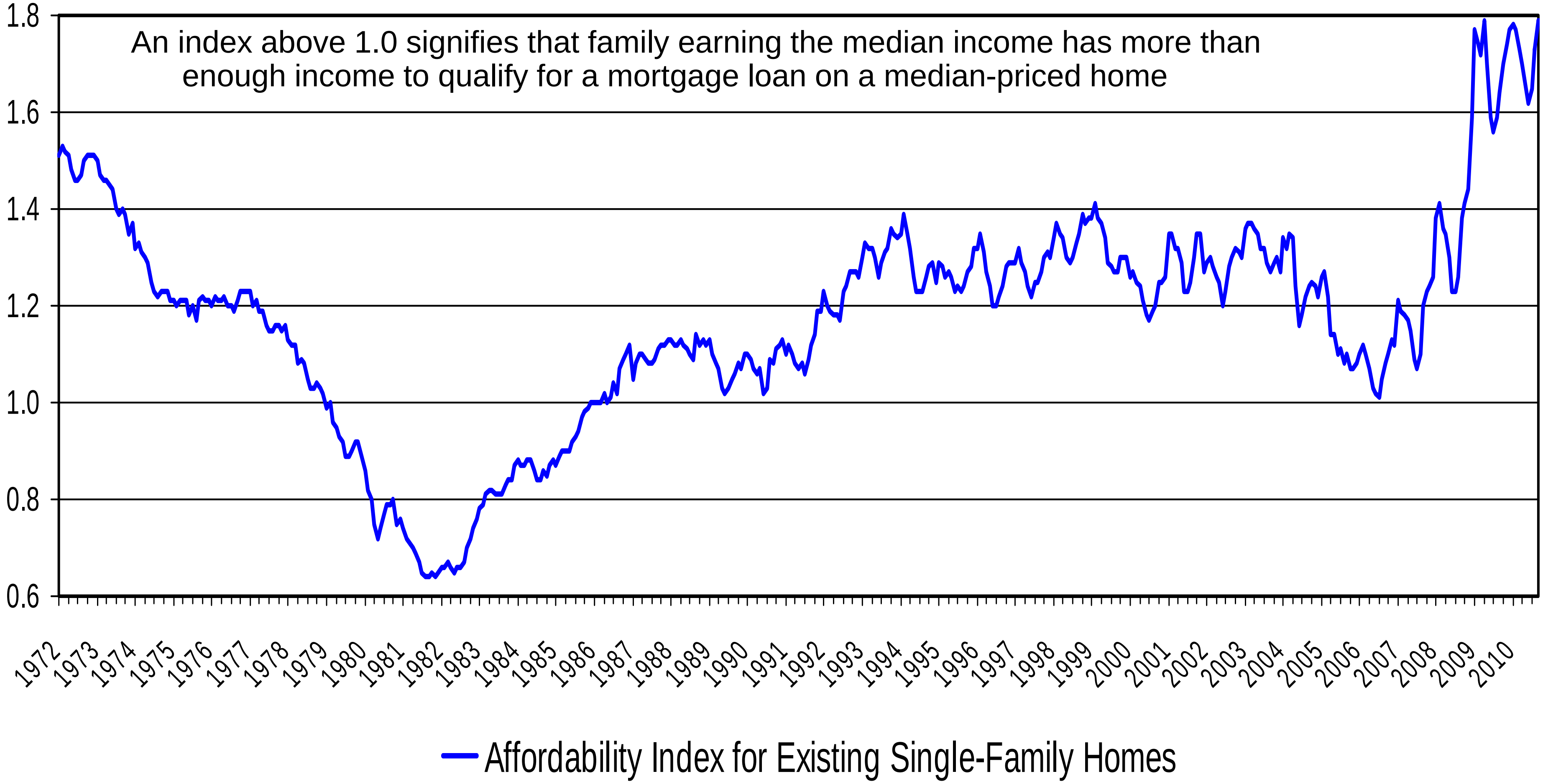

Source: Mortgage Bankers Association (MBA)

# Months Supply of Homes on the Market Has Risen Sharply Nationally


- Again, national trends are driven by a few keys states – Virginia, while still experiencing higher than optimal inventories statewide, is far better than the nation as a whole
- Northern Virginia Realtors Association estimates there are less than 4 months of inventory available in that region
- In the Fredericksburg area the rate is at 7 months
- Supplies still high in Hampton Roads region

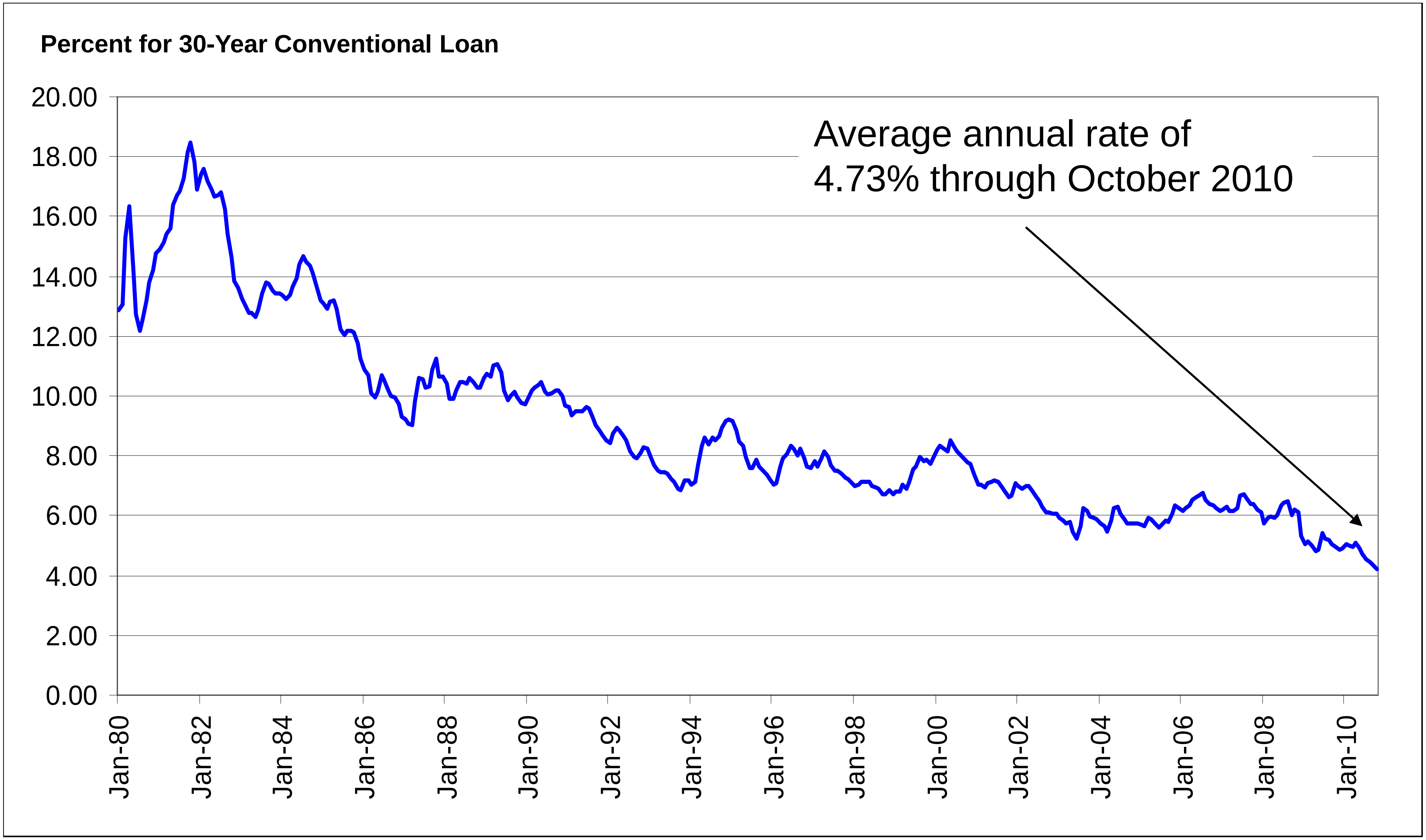
# Nationally, Housing Affordability is at a Record High

**A higher index means homes are more affordable**




Source: National Association of Realtors

# Mortgage Rates At All Time Low




Source: Federal Reserve Board

# In Summary

- Market conditions will remain challenging for the next several years until the foreclosure problem is resolved and economic recovery takes fuller hold
  - The number of homeowners underwater could lead to increased "strategic" foreclosures, especially among un- and under-employed
- Continued high levels of distressed sales will restrain prices and could result in a "double dip" in prices in some markets
- Long-term home appreciation will depend on employment and income growth, and will not be at the rates seen in the first part of the decade
- It does appear improvement is finally on the horizon, but housing clearly will not lead the rebound as it has following previous recessions
  - We aren't building our way out of this recession

# Update on Consumer Spending and Housing Market

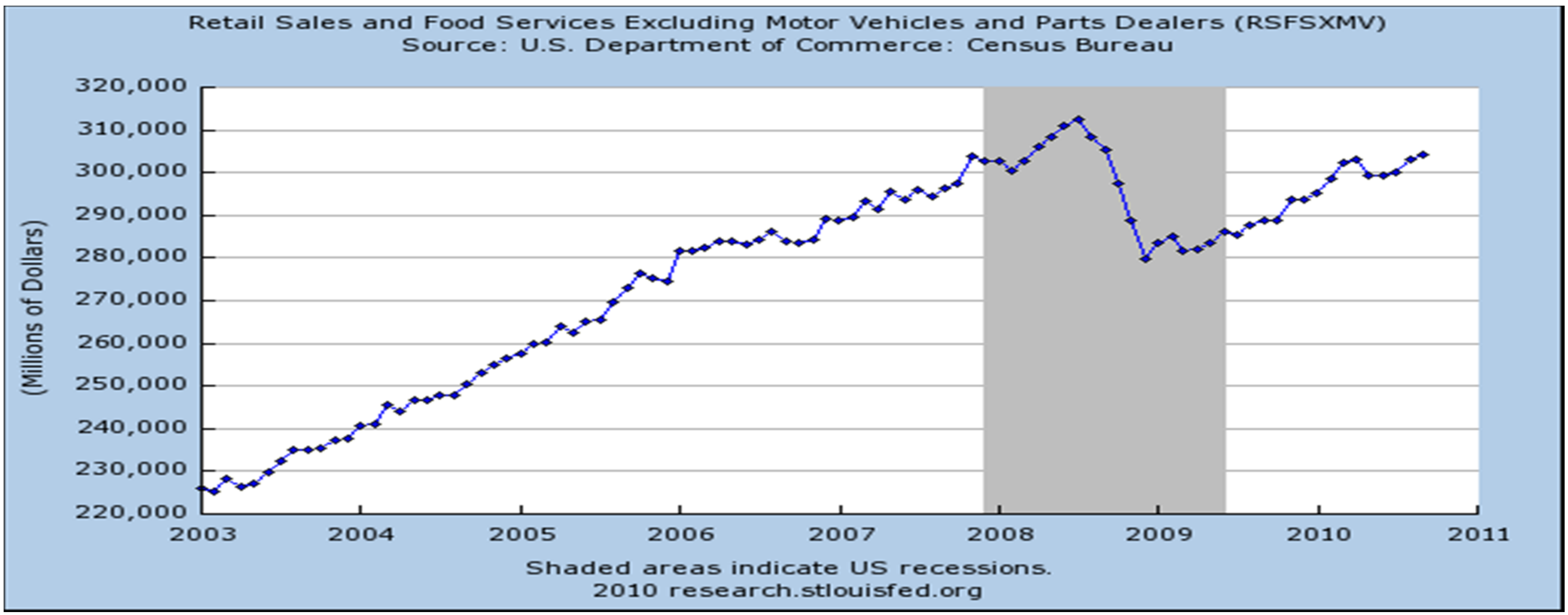
## Consumer Spending

# What is Needed to Spur a Strong Consumer Recovery?

- Consumer spending accounts for two-thirds of economic activity
- During previous recessions, consumer spending remained on the rise or contracted slightly for only one year and when the recovery began, pent up demand drove high increases in retail sales
  - In FY 2004 sales tax revenues grew 10.1% in Virginia
- But the recent recession was far deeper and has been marked by record-setting drops in consumer spending and confidence
  - Consumer spending fell in both CY 2008 AND CY 2009 before beginning to growing this year

# Nationally, Retail Sales Have Rebounded – But Retail Sales Still Below 2008 Levels

- While retail sales have improved fairly consistently since December 2008, the annualized change is compared to historic drops in retail sales
  - Even with one year of growth, only now are retail sales returning to 2007 levels and are still below the peak in 2008
  - On a monthly basis, seasonally adjusted national retail sales increased 1.2% in October, and sales between August and October have grown 6.3% compared to 2009

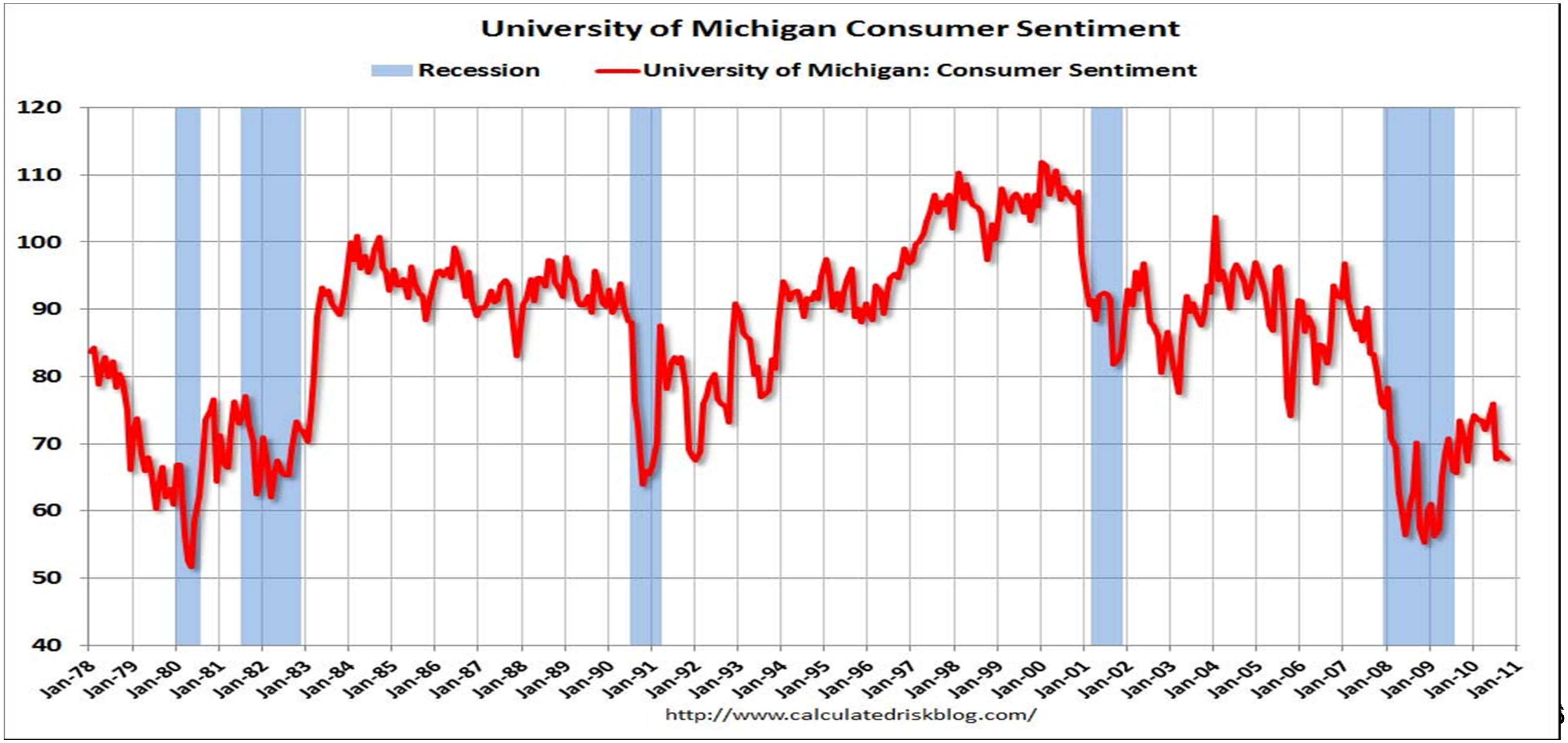


# Short Term Pain, Long Term Gain

- Why is it different this time?
- Consumer confidence remains low, with high unemployment leading to continued concerns about the state of the economy in the future
- Consumers have continued to place debt reduction and increased savings at the top of their agendas – not resumption of deferred expenditures
- "Wealth" effect still is dampening consumer spending as housing values remain stagnant and the stock market has yet to recover all of the losses
- Consumers continue to deleverage and total consumer borrowing has dropped 18 times over the last 20 months
  - Revolving credit, which includes credit cards, has fallen 25 consecutive months, dropping by an annual rate of $8.3 billion
- While trends to reduce outstanding debt and increase savings hamper spending in the short run, they help support long-term economic health

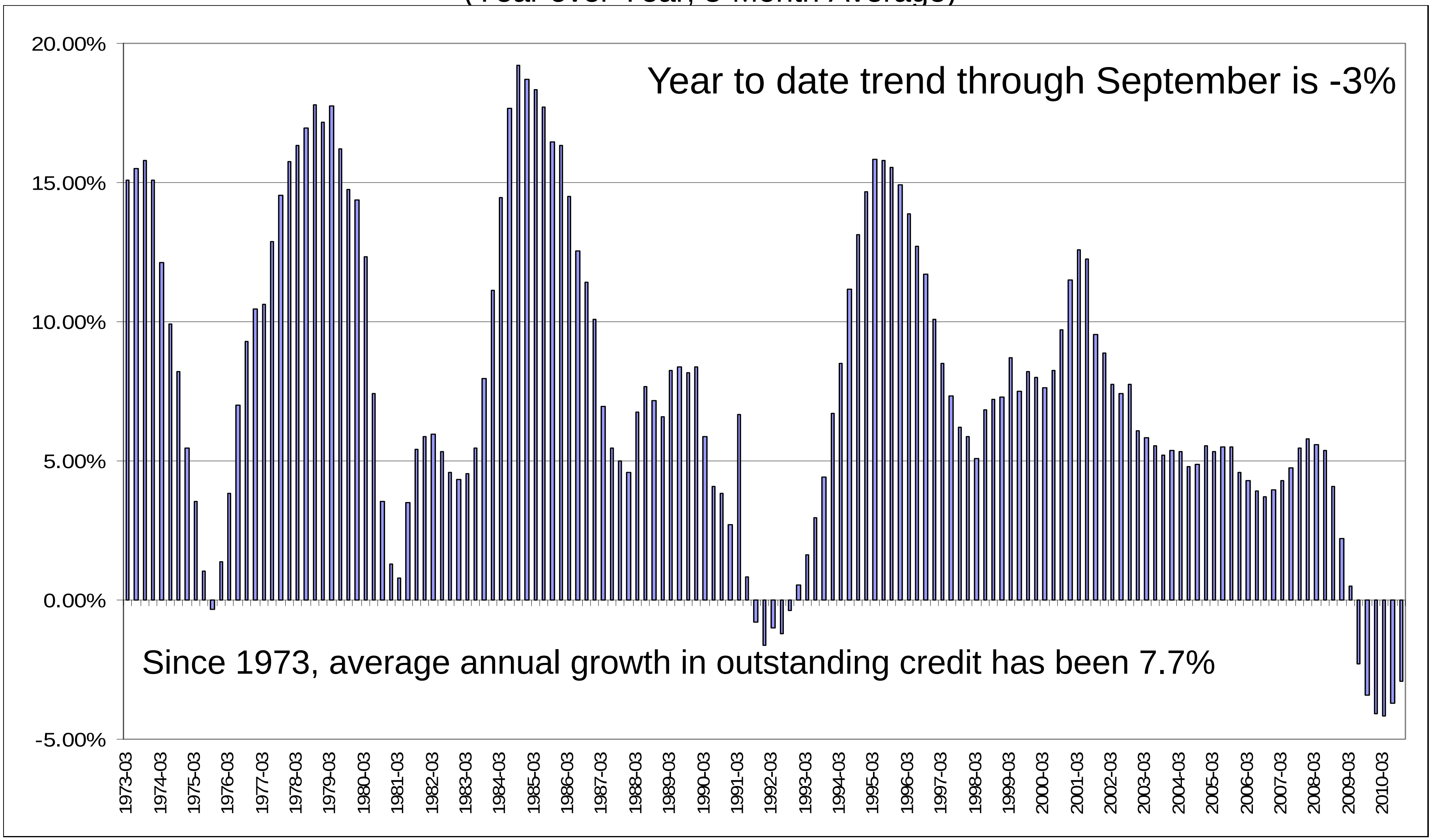
# Plummeting Consumer Confidence Has Ended, But…

- October consumer confidence report pegged confidence down about 4% points since last October, based largely on low confidence for future conditions
- Confidence still hovers at levels equal to the low point during the 1990s recession; the only other time it has been in this range was the early 1980s



# Percent Change in All Outstanding Consumer Credit

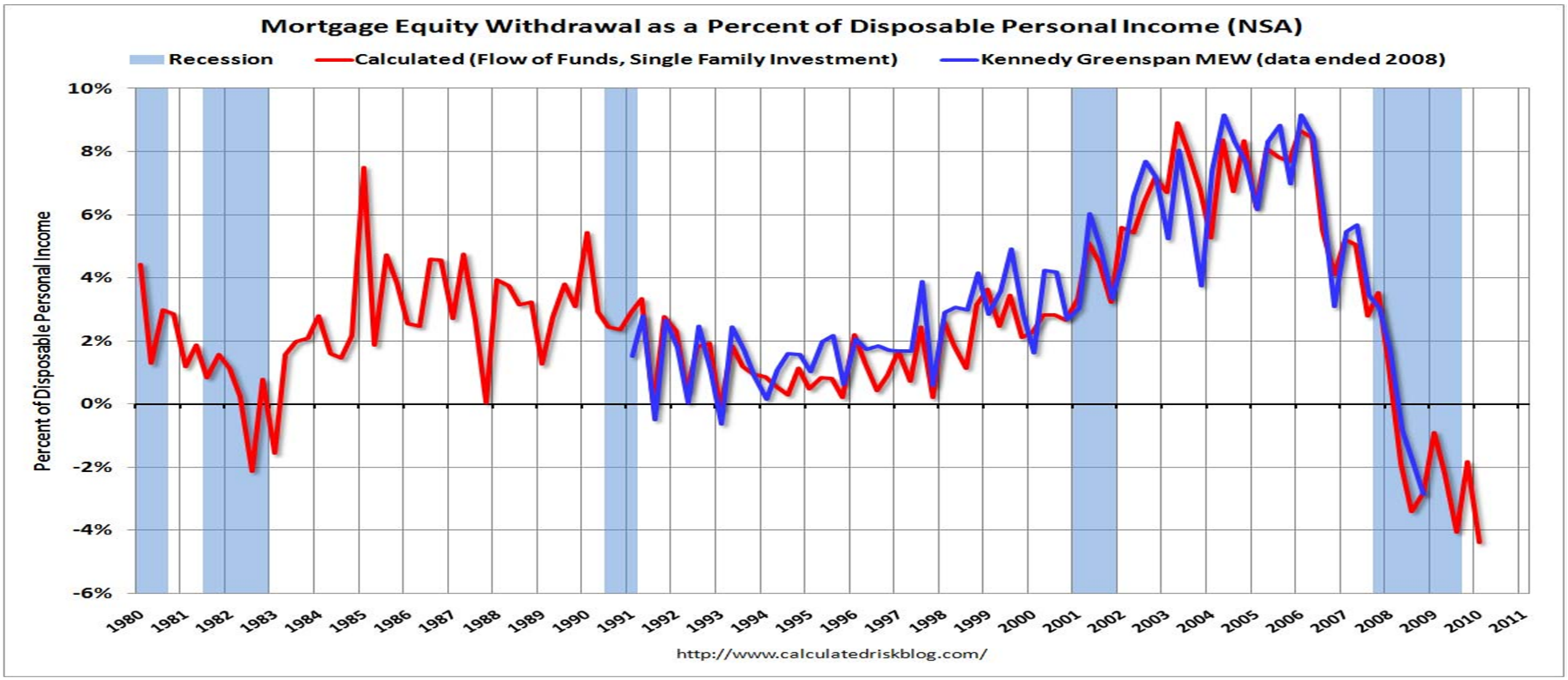
(Year over Year, 3-Month Average)



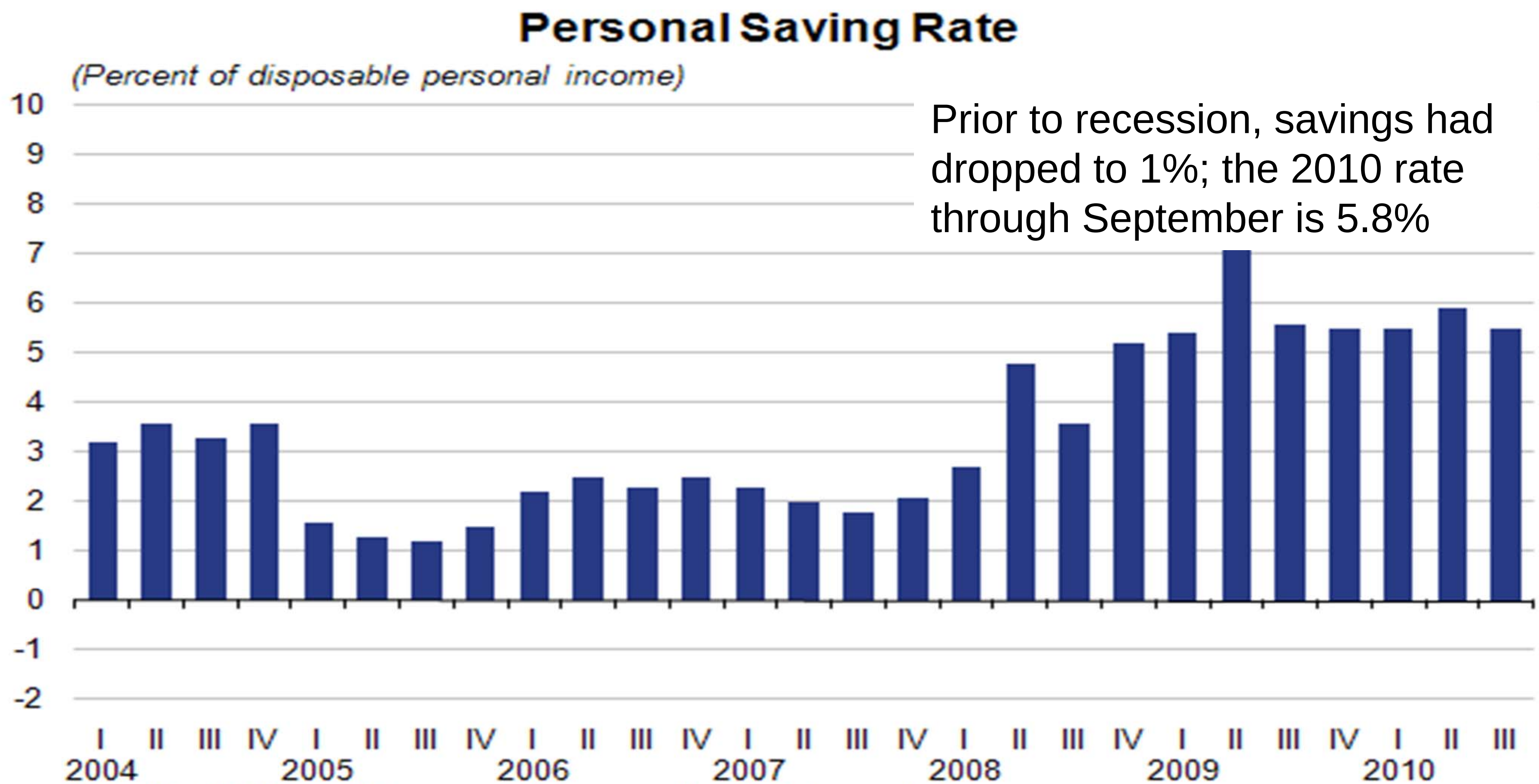

Source: Federal Reserve. Consumer credit includes all revolving and non-revolving credit exclusive of home loans.

# Consumers Not Using Home Equity to Support Spending

- During the housing boom, mortgage equity extraction substantially boosted total consumer spending
  - Equity extraction made up in excess of 8% of total disposable income in the 2004-06 timeframe; over last 2 years it has fallen to -4% as homeowners pay down equity lines and/or are ineligible for further loans



# Personal Savings Rates Grew throughout Recession

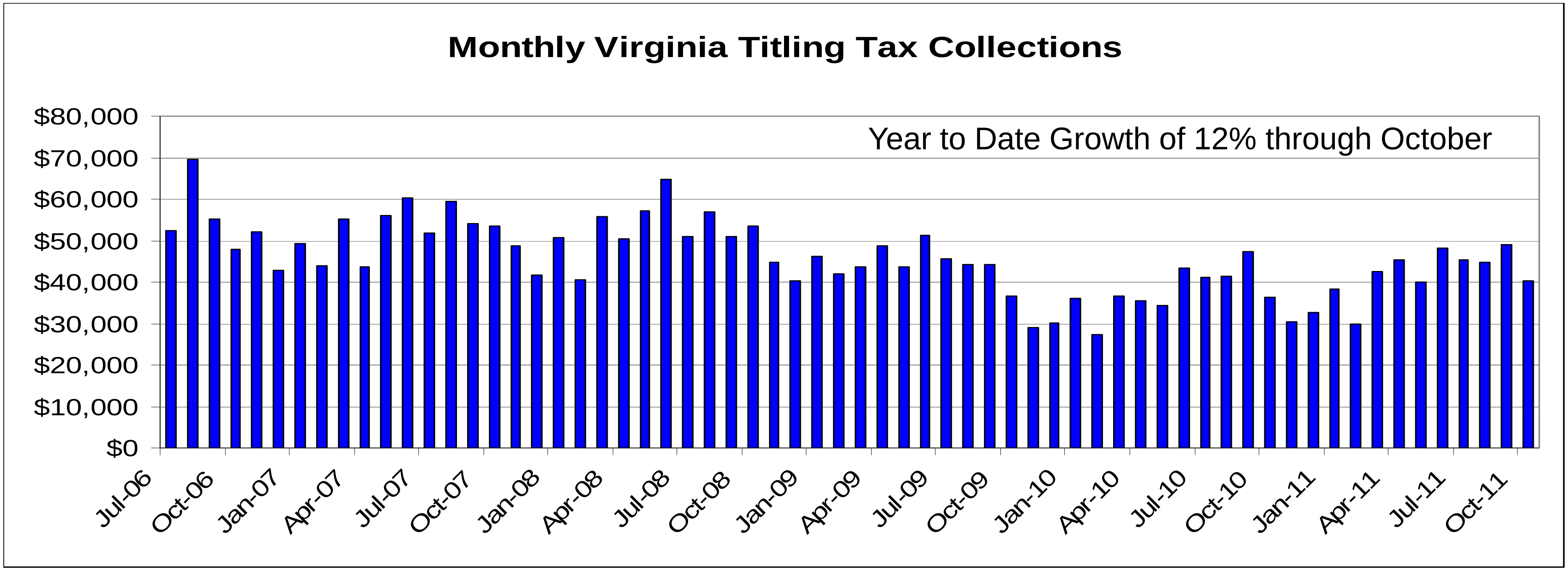



Prior to recession, savings had dropped to 1%; the 2010 rate through September is 5.8%

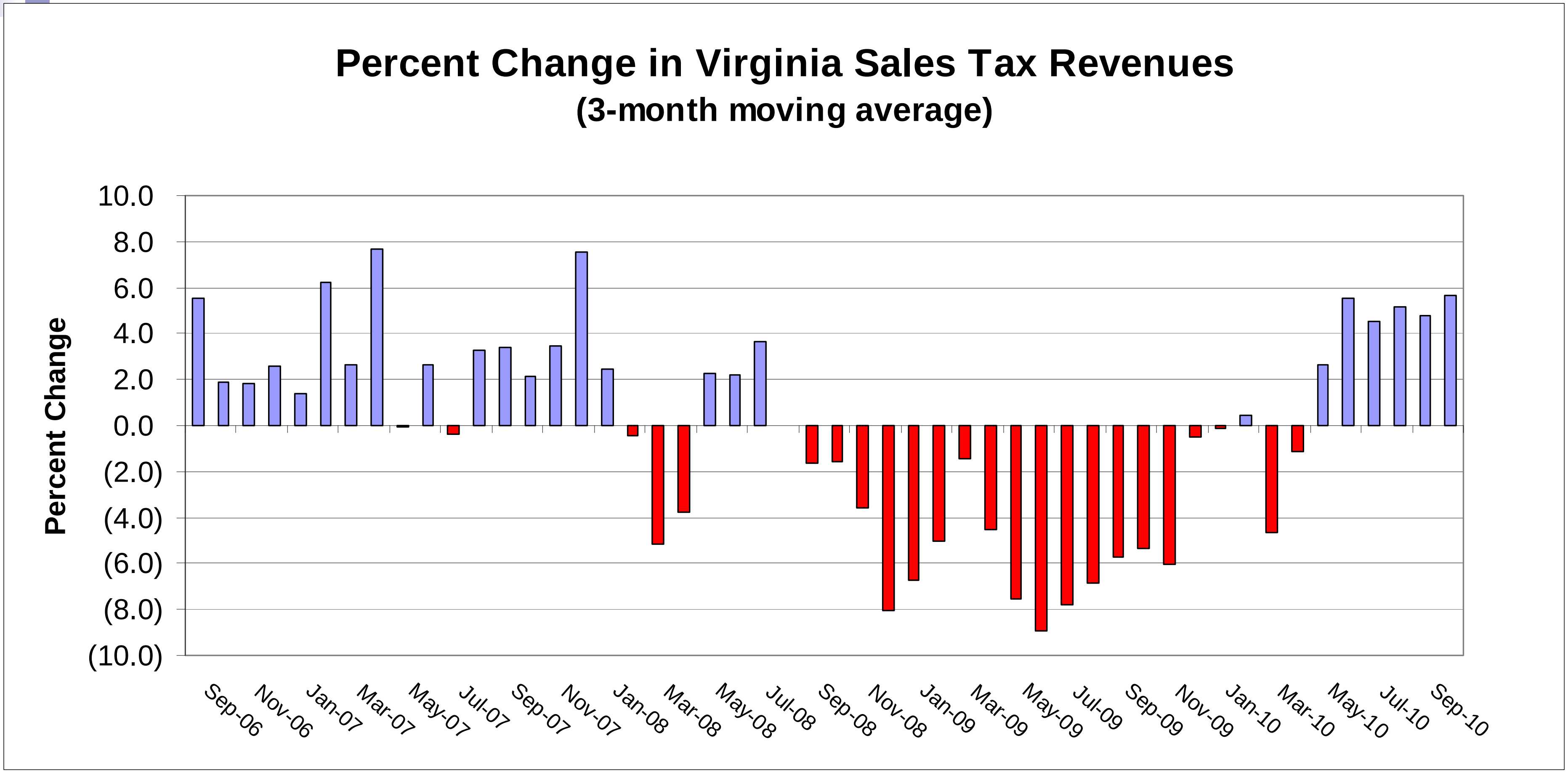
Note. Real GDP growth is measured at seasonally adjusted annual rates.

U.S. Bureau of Economic Analysis

# Auto Sales Show Slight Improvement




- Based on an estimate from Autodata Corp, national light vehicle sales were up 18% from October 2009 and sold at a 12.26 million SAAR in October
- Represents the highest sales rate since September 2008, excluding Cash-for-clunkers in August 2009
- Virginia is seeing a similar increase, with the Virginia Automobile Dealer's Association reporting year-to-date sales growth through September 2010 exceeding 2009 sales by 11%
  - While still 10% below 2008 levels, Virginia auto sales have shown improvement on a year over year basis for 7 of the first 10 months of this year, even compared to sales spurred by cash for clunkers




- Exclusive of AST, Virginia retail sales tax collections are up 5.3% through October on a year-over-year basis compared to a forecast of 0.8% growth
  - Every 1% in sales tax generates just under $30 million to the GF
- Monthly sales tax revenues have grown for past 7 months – with average growth since April of 5.4% - expect to see an adjustment in this source in December

# Retail Rebound on the Horizon?

- Does this trend in sales tax collections suggest we are we seeing the start of a turn-around in consumer spending?
- Yesterday's report on consumer spending showed the largest increase since March this past month
  - Also included were upward revisions to August and September sales
- National Retail Federation (NRF) projects holiday sales to rise 2.3% this year
  - Early reports of holiday season retail hiring show retailers hired 150.9 thousand workers (NSA) net in October. This is about the same level as in 2003 through 2006
  - A NRF survey on holiday shopping show consumers report they will spend slightly more on gifts this holiday season after 2 years of declines
- Reports on company-specific store sales having been showing substantial year-over-year increases, especially at the higher end and certain specialty stores
  - Of the 28 chains tracked by Reuters, 14 beat sales expectations in October
  - October marked 14th consecutive month of increases for retailers

# Balancing Virginia's Budget

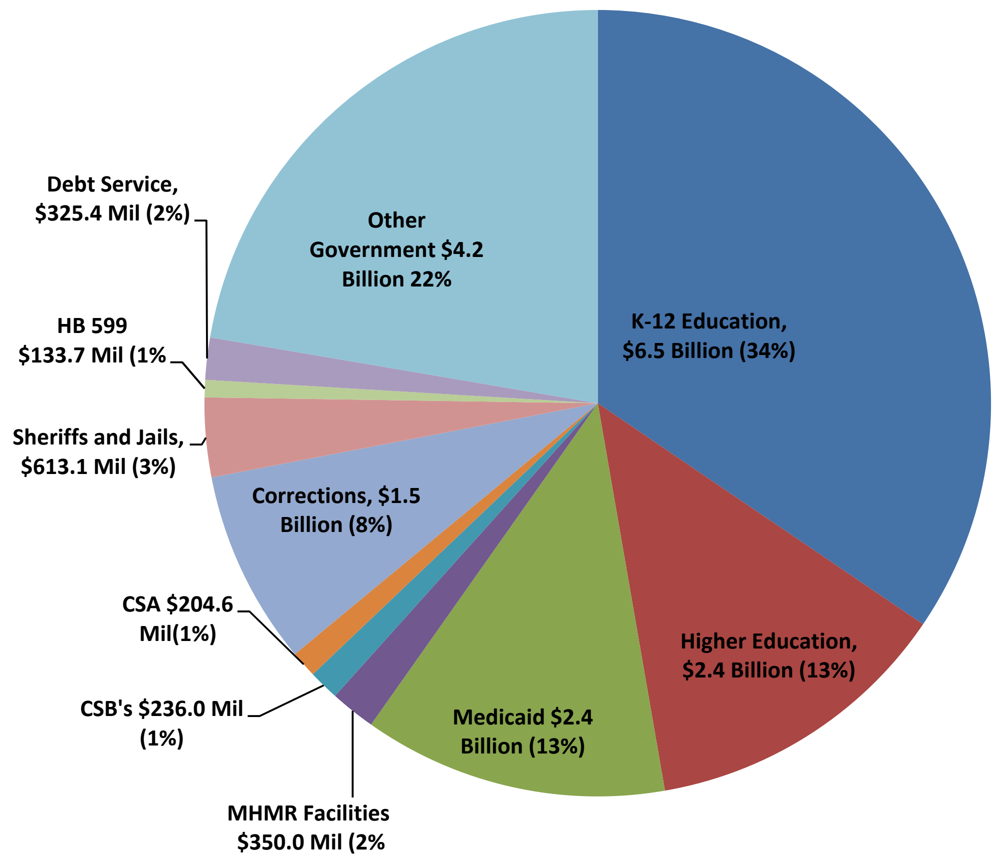
- Comparison of General Fund budgets
  - 1998-2000
  - 2010-2012
- Coming out of the 2001 recession the budget grew substantially
  - Where did it go?
- Review of actions to balance Virginia's budget 2008-2010 and the 2010-12 biennial budget
  - How did we manage the budget?
- Revenue Outlook
  - FY 2010 performance
  - FY 2011 year-to-date collections
  - 2011 Session revenue adjustments
- 2011 Session Budget Issues
  - Usual suspects driving the budget
- Looking Ahead to the 2012-14 Biennium
  - Are we structurally balanced?
  - What are the drivers?

# How Has Spending Changed From The 1998-2000 Biennium To Today?

# Spending As A Percent Of The GF Budget

*1998-2000 Biennial Budget*

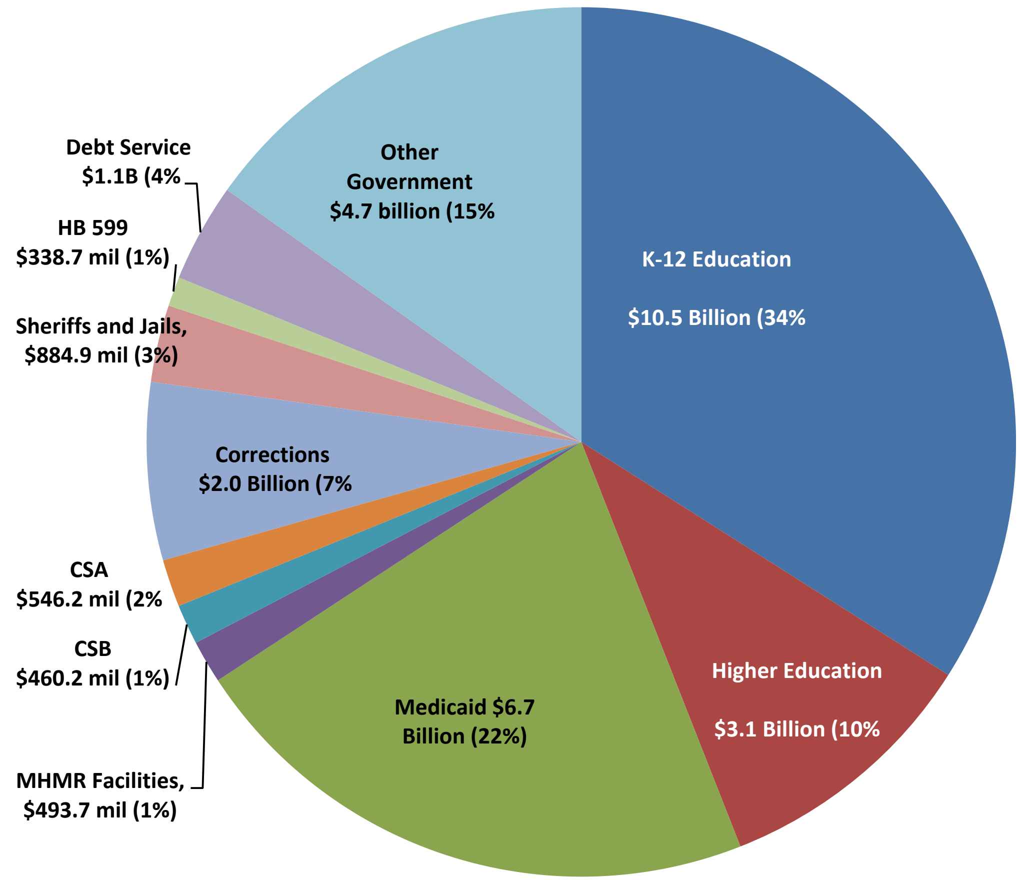
- K-12 comprised 34% of the general fund biennial budget
- Medicaid and Higher Education at $2.4 each, represented 13% of the general fund budget, respectively
- "Other government" represented 22% of total general fund spending



# Spending As A Percent Of The GF Budget

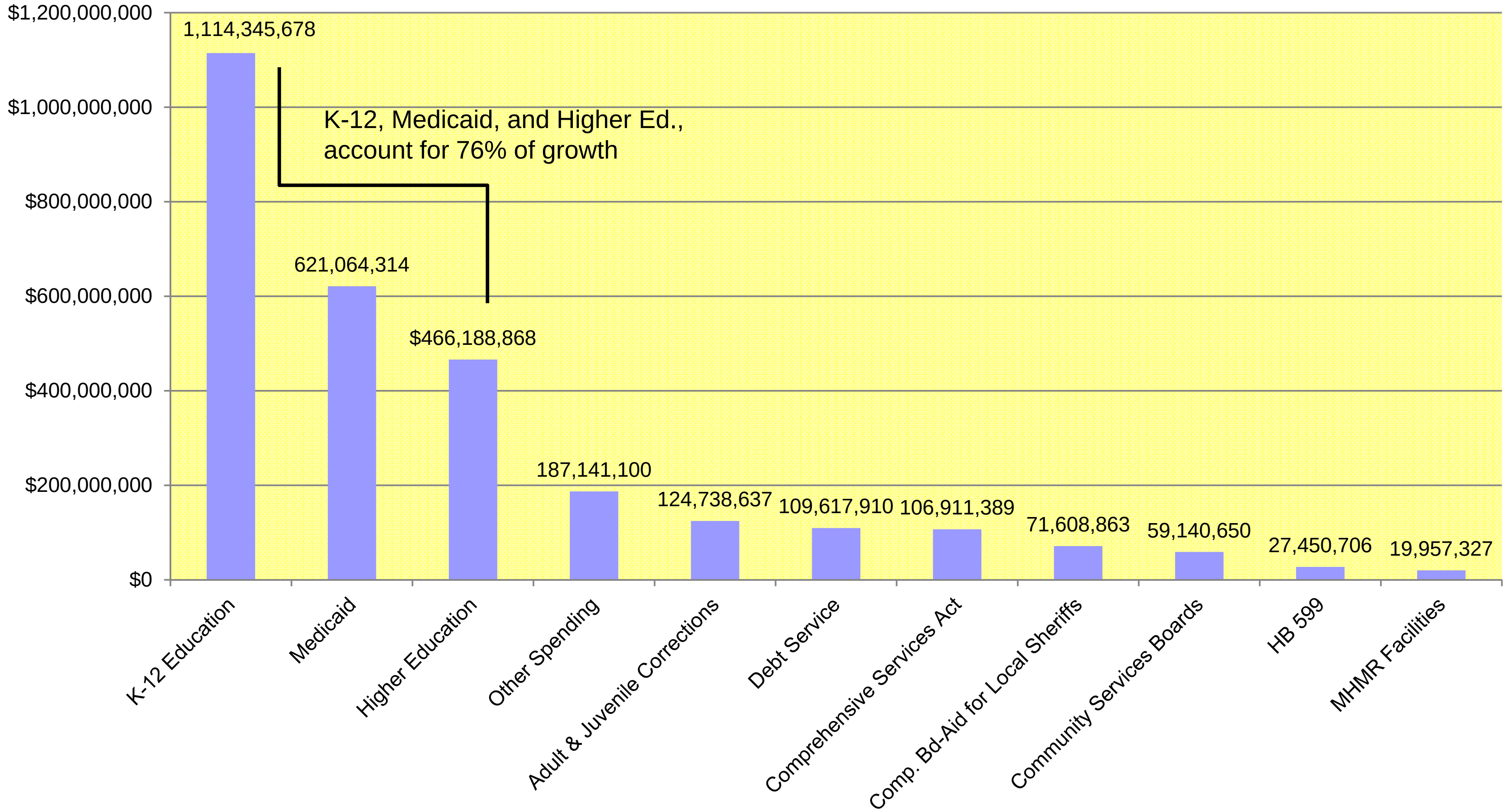
*2010-12 Biennial Budget*

- Over the decade, Medicaid has seen a three-fold increase in spending
  - Now represents 22% of the GF budget
- K-12, has grown 61% since 1998-2000 and remains unchanged at 34% of the GF budget
- To help pay for the growth in Medicaid and K-12, general fund support for Higher Education, Corrections and the rest of government shrunk as measured as a percent of general fund spending



# Coming Out of the 2001 Recession The Budget Grew $2.9 Billion -- Where Did It Go?

*GF Budget Growth From FY 2005 – FY 2008*

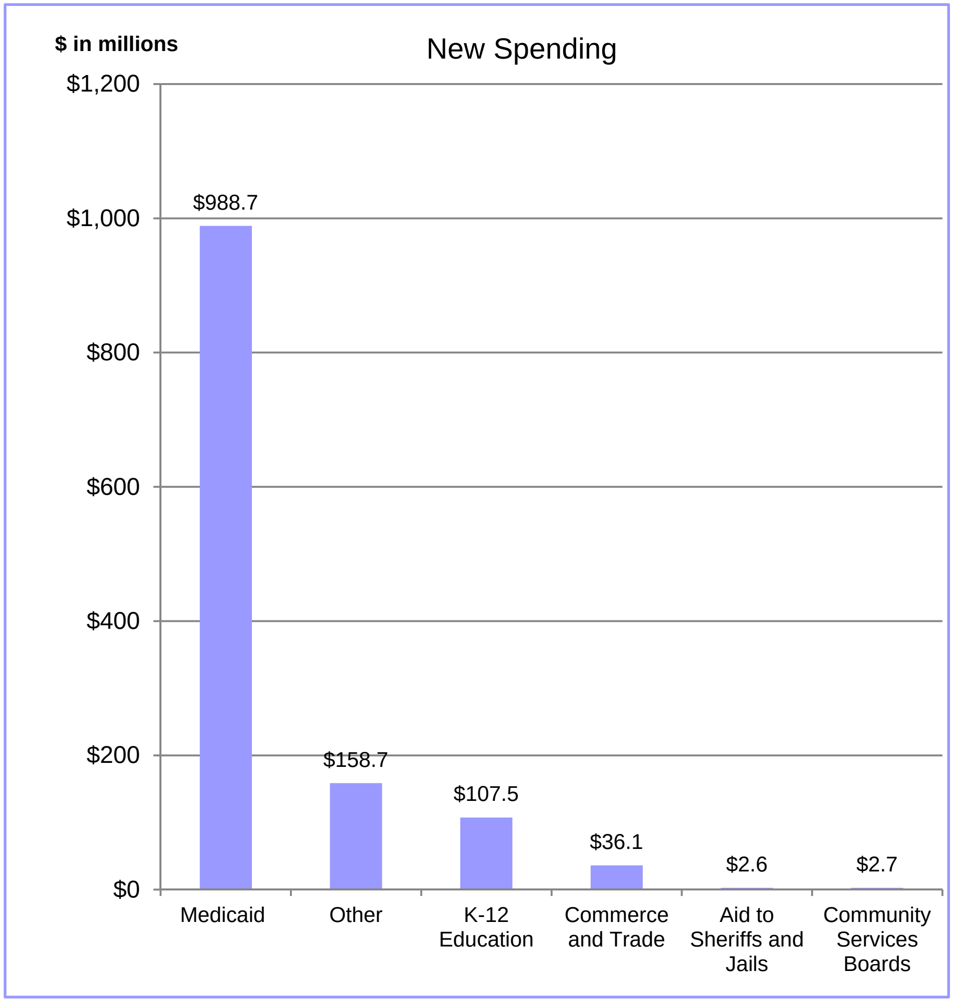


# By Fiscal Year 2008 General Fund Revenues Began To Decline With A Total Of 5 Downward Adjustments To The Forecast

- The FY 2008-10 budget was balanced using a wide variety of strategies, including:
  - Rainy Day Fund:  $783 million
  - Capital Outlay reversions:  $452 million
  - Capturing of balances: $218.5 million
  - NGF transfers:  $224.7
  - Adjustments to fringe benefits:  $336.3 million
  - Eliminate salary increases:  $239.8 million
  - Shifting provider payment schedules:  $132.5 million
  - ARRA - enhanced FMAP: $1.1 billion
  - Agency budget cuts:  $2.0 billion
- Magnitude of agency reductions increased 3-fold between FY 2009 ($452.9 m.) and FY 2010 ($1.5 billion)
  - Ongoing agency reductions represent 37% of strategies used to balance out FY 2010

# Below Trend GF Revenue Growth For 2010-12, Coupled With Budget Drivers, Required Additional Budget Balancing Actions

- Major actions included:
  - Carry-forward balance from FY 2010 -- $132.2 million
  - Continuation of the September 2009 Executive budget reduction -- $716.0 million
  - Targeted budget reductions - $1.5 billion
  - VRS savings -- $849.8 million
  - NGF transfers & balance reversions -- $71.2 million
  - Tax policy adjustments & fee increases -- $141.6 million
  - Additional FMAP Funds -- $370.4 million
    - The actual amount Virginia received is $265.8 million



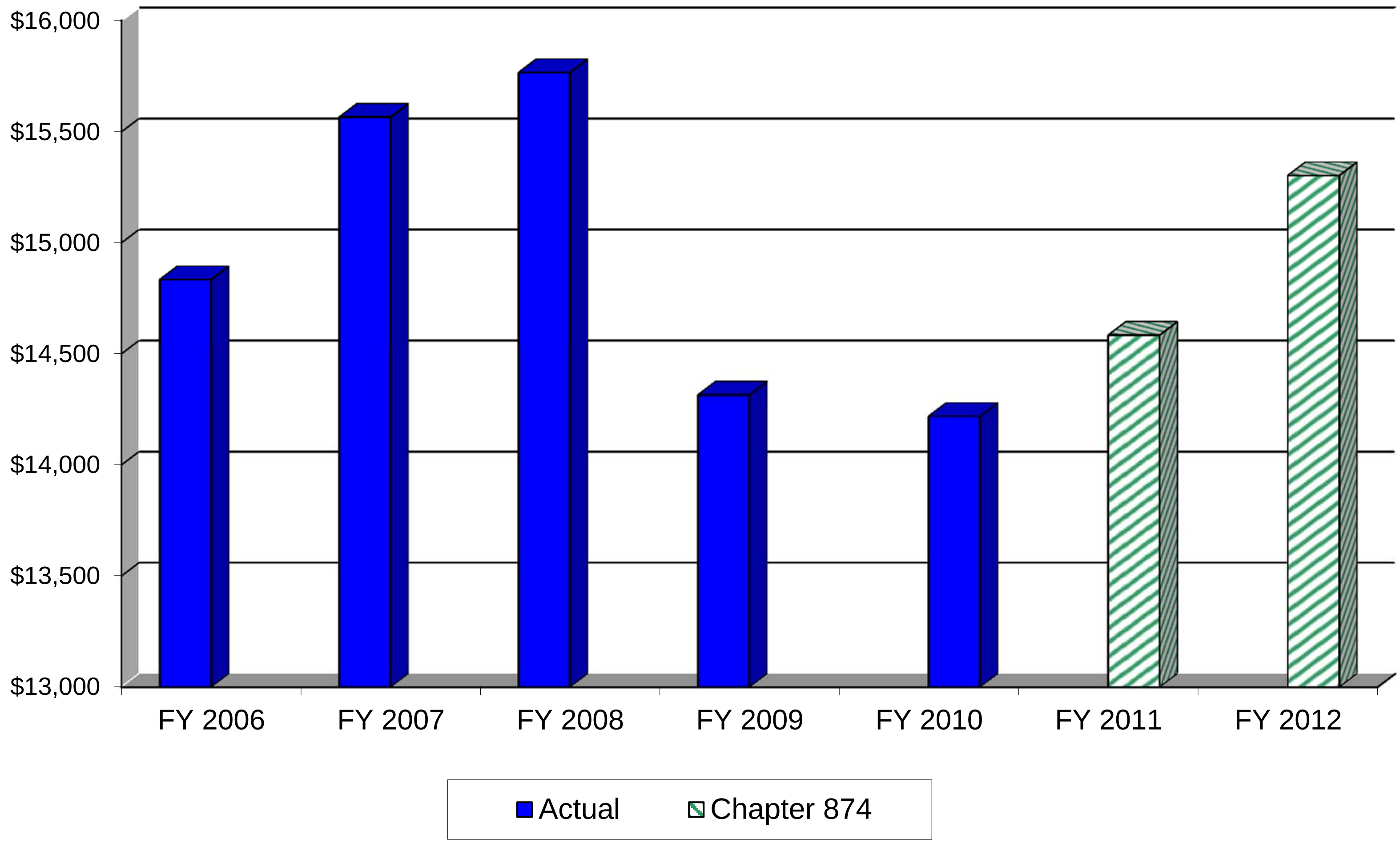
# General Fund Revenue Outlook

**Money in the bank tells no lies?**

# The Fall Forecasting Process Began In October

- Significant revenue elements used in the fall forecasting process will be available over the next few months and will be incorporated in the fall forecasting process
  - October –
    - Retailer corporate estimated payments are due
    - JABE review economic projections for current and next biennium (Oct. 20th)
  - November –
    - Corporate refunds from extension returns peak
    - GACRE reviews revenue forecast for fiscal years 2011 and 2012
  - December
    - General fund revenue forecast finalized
    - Governor McDonnell's amendments to the 2010-2012 budget are presented to the Joint Money Committees on December 17

# Current GF Forecast For The 2010 - 2012 Biennium Below FY 2007 Levels



# Fiscal Year 2010 Revenues Exceeded Expectations
# Is the 4th Quarter Trend Telling Us Something?

- FY 2010 revenues exceeded forecast by $228.5 million
  - Revenues were negative 0.7% versus negative 2.3%
  - Two consecutive years of negative growth
    - 1991 and 2002 were the only other years we saw negative revenue growth
- Corporate and nonwithholding taxes accounted for $170.0 million (75%) of surplus, yet represent 20% of total general fund revenue
  - Corporate gains reflect cost cutting measures as companies squeeze profits and hoard cash
  - Nonwithholding reflects gains in the stock market
- Payroll withholding (64% of total GF ) grew 0.4%
  - Underscored weakness in employment and wages and salaries
  - On the positive side, last 4 months of the fiscal year grew 5.8%, in excess of the annual forecast
- Sales tax revenues experienced another decline
  - But, April through June sales tax saw an increase of 5.5% over the same period in FY 2009

# Fiscal Year 2010 Revenues and Transfers Finished $228.5 Million (1.6 Percent) Above Forecast

**Summary of Fiscal Year 2010 Revenue Collections**
(millions of dollars)

| Major Source | Forecast | Actual | Variance Dollars | Variance Percent | Annual Growth |
|---|---|---|---|---|---|
| Withholding | $ 9,153.4 | $ 9,176.2 | $ 22.8 | 0.2 % | 0.4 % |
| Nonwithholding | 1,813.2 | 1,906.8 | 93.6 | 5.2 | (17.5) |
| Refunds | (2,006.5) | (1,994.7) | 11.8 | (0.6) | 1.4 |
| Net Individual | 8,960.1 | 9,088.3 | 128.2 | 1.4 | (4.1) |
| Sales | 3,043.0 | 3,082.5 | 39.5 | 1.3 | 6.2 |
| Corporate | 730.7 | 806.5 | 75.8 | 10.4 | 24.4 |
| Wills (Recordation) | 299.0 | 290.2 | (8.8) | (2.9) | (7.7) |
| Insurance | 242.5 | 261.9 | 19.4 | 8.0 | 2.7 |
| All Other Revenue | 713.3 | 690.2 | (23.2) | (3.2) | (3.2) |
| **Total Revenues** | **$ 13,988.6** | **$ 14,219.5** | **$ 230.9** | **1.7 %** | **(0.7) %** |
| ABC Profits | 42.2 | 50.0 | 7.8 | 18.4 | 13.3 |
| Sales Tax (0.25%) | 204.5 | 209.4 | 4.9 | 2.4 | (1.9) |
| Transfers | 322.9 | 307.8 | (15.1) | (4.7) | 106.6 |
| **Total Transfers** | **$ 569.6** | **$ 567.2** | **$ (2.4)** | **(0.4) %** | **39.5 %** |
| **Total General Fund** | **$ 14,558.2** | **$ 14,786.7** | **$ 228.5** | **1.6 %** | **0.4 %** |

- Total revenues declined in two consecutive years for the first time in 50 years
- The only other years in which revenues fell were FY 1991 and FY 2002

# Where Did the FY 2010 General Fund Surplus Go?

| | $ in Millions |
|---|---|
| Revenue Surplus: | **$228.5** |
| | |
| Uses: | |
| Three percent bonus to state employees | 82.2 |
| Water Quality Fund | 36.5 |
| Accelerated Sales Tax for Transportation Trust Fund | 27.7 |
| Additional Sales Tax to K-12 | 18.7 |
| Natural Disaster Authorizations (sum-sufficient) | 13.2 |
| Federal Portion of Dominion Resources Refund | 1.2 |
| Total Designations | 179.5 |
| | |
| Remaining Balance: | 49.0 |
| To Transportation Trust Fund (2/3) | 32.7 |
| To Nonrecurring Expenditures (1/3) | 16.3 |
| | |
| Unallocated Surplus: | **$0.0** |

# So Does FY 2010 Performance Suggest a Stronger FY 2011?

- While total FY 2010 GF revenues performed better than expected, payroll and sales tax collections appeared to be at anemic levels
  - The nature of tax collections is that revenue growth lags coming out of a recession
- However, a closer look at quarterly performance suggests that the indicators are pointing to a slight economic improvement
  - FY 2011 1st quarter payroll withholding suggests that the growth trend seen in FY 2010 Q4 is continuing
- First quarter sales tax collections (adjusted for AST) are stronger than the forecast
- September and October are important months for revenues, both nonwithholding and corporate taxes
  - Corporate has performed slightly better than forecast
  - Nonwithholding appears to be in-line with the forecast

# Summary of Fiscal Year 2011 Revenue Collections - July through October

| Major Source | Revenues | | Actual | | Estimate | | Variance |
|---|---|---|---|---|---|---|---|
| Withholding | 64.4 | % | 4.3 | % | 2.4 | % | 1.9 |
| Nonwithholding | 14.5 | | (5.5) | | 11.0 | | (16.5) |
| Refunds | (13.2) | | (16.4) | | (3.5) | | (12.9) |
| Net Individual | 65.7 | | 4.6 | | 5.5 | | (0.9) |
| | | | | | | | |
| Sales | 19.8 | | (13.7) | | (6.5) | | (7.2) |
| Corporate | 5.4 | | 1.7 | | (1.7) | | 3.4 |
| Wills (Recordation) | 2.2 | | (4.1) | | 8.2 | | (12.3) |
| Insurance | 1.9 | | NA | | 4.8 | | NA |
| All Other Revenue | 5.0 | | (14.7) | | 6.3 | | (21.0) |
| | | | | | | | |
| **Total** | **100.0** | **%** | **(0.4)** | **%** | **2.6** | **%** | **(3.0)** |

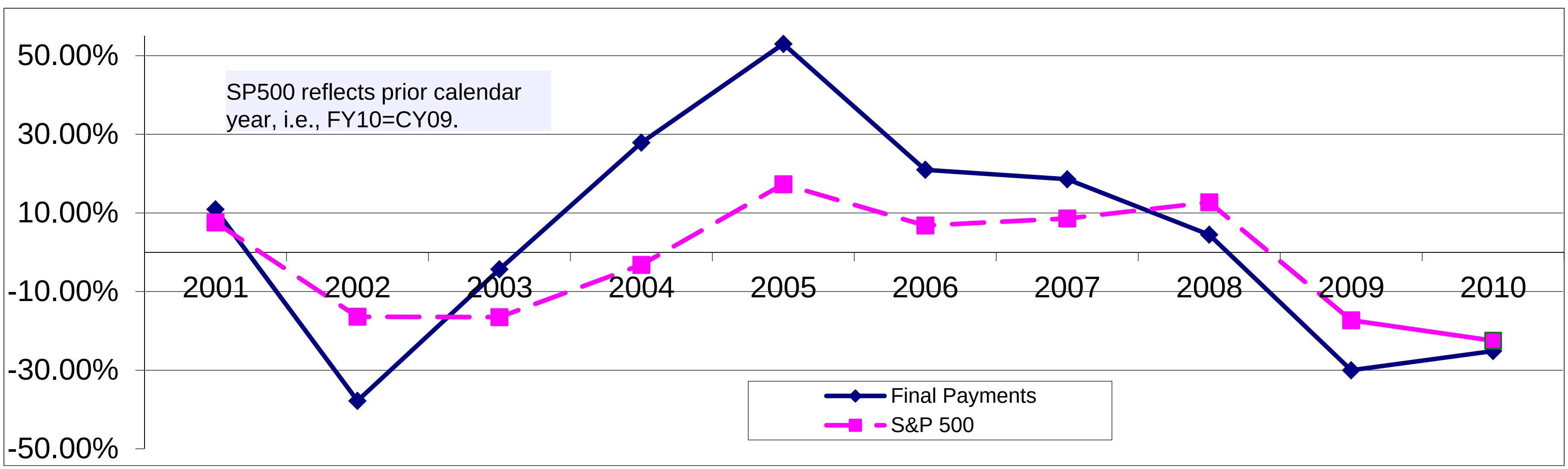
*Adjusted for AST, total revenues grew 3.6% through October, slightly lagging the economic-base forecast of 4.2% growth

# Year-to-Date Withholding Tax Collections Appear to Be Continuing the Trend

- Payroll Taxes: Forecast for year is +2.4%, actual collections through October grew 4.3%
- Over the last 15 years, Virginia has collected, on average, 31.2% of the year's withholding taxes in the first 4 months. Through October, 31.8% of the year's forecast has been collected
  - If this historic ratio is assumed, we would be about $ 162.7 million ahead on this source;
  - Using shorter (10-year) and longer (20-year) comparison periods (10 and 20 year), current collections would be between $71.4 to $170.8 million ahead of forecast
  - Because withholding taxes account for 64% of total GF revenues (gross of refunds), even small swings have substantial revenue impacts

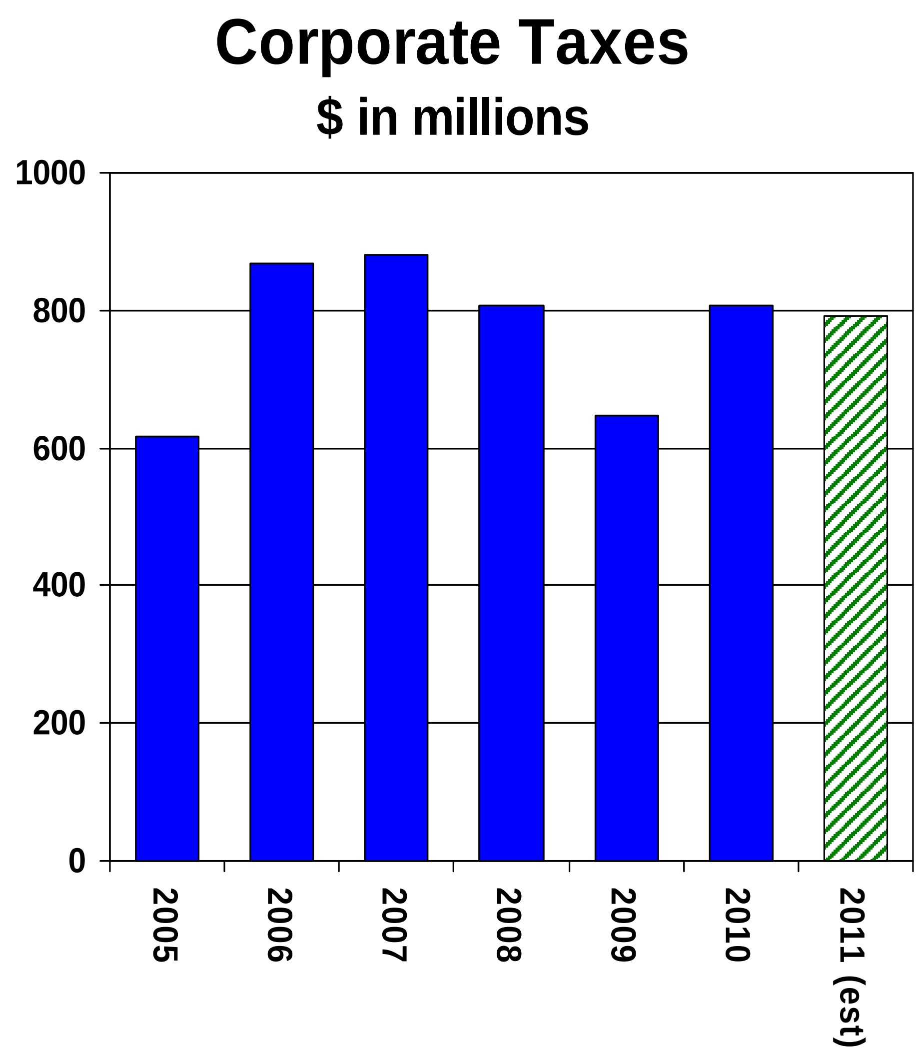
# FY 2011 Nonwithholding In Line With The Forecast

- Forecast assumes11.0% growth
  - Through October collections were at -5.5%
  - Historical analysis of 1st quarter collections suggest that year-to-date collections are in-line with the forecast
- Final payments, which account for 1/3 of revenue, tend to track S&P 500 performance – through the first of November, the S&P was up 9%
  - Forecast assumes a 20% increase in final payments
- At this point in the process, it is too early to tell whether adjustments to the non-withholding forecast are warranted. Need to look at January payments

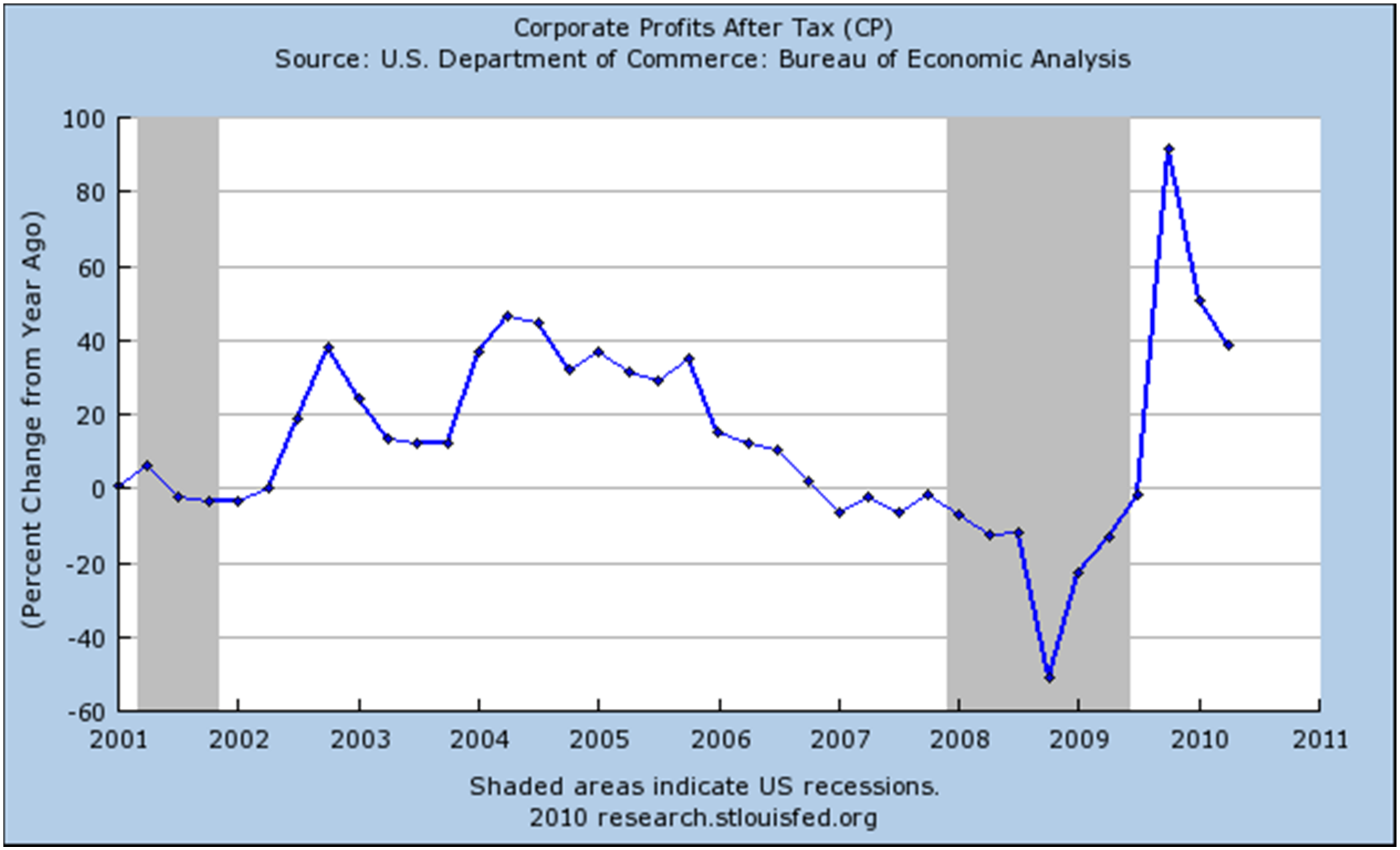


# FY 2011 Corporate Tax Collections

- Corporate income tax is are the most volatile of major tax sources and does not lend itself to an easily discernible growth trend
  - Forecasting is difficult due to safe harbor rules,  carry back and forward rules which allow companies to smooth out their income tax liability, and depreciation schedules
- U.S. corporate profits continue to set records
  - Based on preliminary 3rd quarter estimates, 76% of the S&P companies beat their earnings estimates
- FY 2011 forecast for corporate taxes is negative 1.7%. Through October collections were up 1.7%
  - Collections need to be adjusted to reflect a large refund that is part of a multi-year agreement
  - Ratio analysis of 1st quarter collection to estimate suggest collections are running slightly ahead of forecast



# Corporate Quarterly Profits: Continue to Show Improvement



# FY 2011 Sales Tax Collections

- Sales Tax revenue forecast for FY 2011 is negative 6.5%
- However, when adjusted for accelerated sales tax (AST) the economic based forecast is 0.8%
- Through October, sales tax collections grew 5.3% compared to FY 2010 levels, with monthly collections at 6.5%
  - Based on ratio of 1st quarter collections to the ratio of collections from 2006 – 2009, collections are running about 4% over forecast -- $100 million
- Each 1% change in the sales tax forecast results in a revenue swing of just under $30 million

# Likely December Forecast Adjustment

- Looking at year-to-date performance of the major general fund revenue sources, one can conclude that additional forecast adjustments for FY 2011 could be in the range of $150 – $175 million
  - Reflects downward adjustments in interest earnings and recordation taxes
  - Assumes no adjustment at this time to the non-withholding forecast
- Revenue adjustments will be reflected in the amendments to the budget in December
- Revenue adjustments in FY 2011 will flow through to the forecast for FY 2012
  - FY 2011 base adjustment means a greater amount in FY 2012, even before adjusting for forecast factors
- Economic outlook would suggest slightly stronger growth for FY 2012 in withholding and sales tax
  - Wage and salaries are forecasted to be stronger in FY 2012 reflecting job gains in Northern Virginia, which pay salaries greater than the state average

# Key Virginia Economic Indicators
# Official and September Standard Forecast
*(annual percent change)*

| | Fiscal Year | | | | | |
|---|---|---|---|---|---|---|
| | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 |
| Employment | | | | | | |
| Official (Oct '09) | (1.3) | (2.6) | 1.1 | 2.1 | 2.2 | 1.7 |
| Sep Standard | (1.6) | (2.1) | 1.0 | 2.0 | 2.1 | 2.0 |
| Personal Income | | | | | | |
| Official (Oct '09) | 1.1 | 1.3 | 3.0 | 3.7 | 4.2 | 4.6 |
| Sep Standard | 1.6 | 1.5 | 2.7 | 3.6 | 4.5 | 4.5 |
| Wages & Salaries | | | | | | |
| Official (Oct '09) | 0.7 | 0.1 | 3.0 | 3.7 | 3.4 | 4.1 |
| Sep Standard | 1.2 | 0.0 | 2.8 | 4.7 | 4.4 | 3.9 |
| Average Wage | | | | | | |
| Official (Oct '09) | 2.0 | 2.8 | 1.9 | 1.6 | 1.2 | 2.4 |
| Sep Standard | 2.9 | 2.2 | 1.8 | 2.7 | 2.2 | 1.9 |

# Other Available Resources

- In addition to surplus revenues, agencies ended FY 2010 with unencumbered discretionary GF balances totaling $71.4 million
  - The Governor has authorized $22.2 million of these amounts to be carried forward by agencies
- The remaining $49.2 million is recommended for reversion and will be available for re-appropriation
- In addition, a total of $103.3 million in balances are available in accounts considered “mandatory” re-appropriations
  - The General Assembly and the Governor (in his proposed amendments to the budget) can choose to revert a portion of these amounts to the General Fund as well

# Final Thoughts on Revenue Outlook

- Year to date deposits look on track or exceeding forecast, with trend lines indicating strength in withholding and sales tax
- National indicators of economic activity appear to zigzag from quarter to quarter, which creates a conflicting pattern to analyze
  - Recent jobs numbers and revisions to prior months data suggest employment is seeing some traction
  - ISM Index has remained above 50 for 15 consecutive months

| Upside | Downside |
|---|---|
| Pent- up demand | Anemic job growth |
| Low inflation/borrowing costs | Lack of consumer demand |
| Liquidity in system (corporate cash) | Prolonged real estate slide |

- For Virginia, the game appears to be ahead of us, not behind us!
  - Cuts to defense spending remains our greatest enemy

# What Are The 2011 Budget Issues

# Preliminary Budget Issues Identified By Agencies

- Public Ed. – technical updates and enrollment changes
- Higher Ed. – end of stimulus dollars in FY 2012
- Medicaid – utilization and inflation forecast/Part D credits/healthcare reform
- FMAP Program Restorations – FY 2011 restored/FY 2012 not restored
- Sexually Violent Predators – caseload growth
- MHMR – staffing and Medicaid re-certifications
- Child Support Enforcement – replace federal stimulus supplant
- Corrections – inmate forecast/closing a prison in FY 2012
- VEC – repayment of federal loans for Trust Fund
- Debt Service – second year requirements
- State Employee Healthcare Insurance – utilization in FY 2012
- VITA Rates – insufficient funding in agencies
- Recommendations from Gubernatorial Commissions

# Current Biennium Budget Issues

| | | $ in millions | |
|---|---|---|---|
| | | FY 11 | FY 12 |
| Federal Tax Conformity - actions taken by Congress in 2010 | | 25.4 | 8.2 |
| Sale of Surplus Property -- Brunswick Prison | | 0.0 | 20.0 |
| *Judicial Department* | | | |
| Criminal Fund Shortfall | | 6.0 | 7.2 |
| Unfreeze Judicial Vacancies | | 0.4 | 1.7 |
| *Public Safety* | | | |
| Inmate Medical Costs | | 0.0 | 16.1 |
| Increased Costs for Private Prison Contract | | 0.9 | 0.9 |
| New Jail Staffing | Blue Ridge Regional Jail -- Amherst Expansion | 0.0 | 3.2 |
| Jail Per Diems | | 7.0 | 4.8 |
| 1:1,500 Staffing Ratio | | 2.3 | 1.6 |
| STARS Maintenance Costs | | 0.0 | 7.6 |
| Offender Reentry Initiatives | | 1.5 | 4.2 |
| HB 599 Payments | For each 1 % in revenue growth | 0.0 | 1.6 |
| Restore Facility Closure | | 0.0 | 10.9 |
| Utility costs | | 0.0 | 6.8 |
| Restoration of Equipment Funding | | 0.0 | 1.3 |
| Compensation Board - Sheriffs | | 8.0 | 22.0 |
| *Economic Development* | | | |
| Various Research, Incentive, and Performance Grants Above Base | | 0.0 | 1.6 |
| *K-12 Education* | | | |
| School for the Deaf and Blind - Furnishings and Maintenance for Buildings | | 0.2 | 0.8 |
| K-12 Sales Tax - Increased Based on Forecast | | ? | ? |

# Current Biennium Budget Issues

| | | $ in millions | |
|---|---|---|---|
| | | **FY 11** | **FY 12** |
| *Higher Education* | | | |
| Financial Aid | | 0.0 | 29.8 |
| Enrollment Growth | | 0.0 | 65.7 |
| O & M New Buildings | | 0.0 | 21.0 |
| VTAG | | 0.0 | 2.5 |
| *Health and Human Resources* | | | |
| Medicaid Forecast | | (39.9) | 205.1 |
| Health Reform Implementation, IT, Audits, MMIS | | 0.0 | 1.8 |
| DBHDS - Backfill FMAP for 250 ID Waiver Slots | | 0.0 | 17.9 |
| ESH - Hancock Geriatric Ctr. Federal Medicaid Loss | | 4.2 | 0.0 |
| SVP - VCBR Facility Operations | | 9.0 | 17.1 |
| SVP - Community | | 0.3 | 0.5 |
| DSS - Unemployed Parents Cash Assistance | | 0.0 | 8.5 |
| DSS - Replace ARRA for Child Support Enforcement | | 0.0 | 6.7 |
| DBHDS - Fund Legislation to Increase Annual ID & DD Waiver Slots per Ch. 228 | | | |
| *Capital Outlay* | | | |
| Debt Service | Assumes Maint. Res, HEETF and Equipment | 0.0 | 22.5 |
| *Technology* | | | |
| Provide Agencies Increases for VITA Charges | | 25.0 | 25.0 |
| Enterprise Systems Loan Repayment | | 0.0 | 21.7 |
| | **Total - Identified Issues** | **50.3** | **563.1** |

# Agency Reduction Plans

- This fall Governor McDonnell requested all agencies to develop 2%, 4% and 6% reduction plans for FY 2012
- The reduction plans submitted to Governor McDonnell total:
  - $312.5 million at the 2% level
  - $625.0 million at the 4% level
  - $937.5 million at the 6% level
- Unlike previous reduction plans, no segment of an agency's GF budget was considered "exempt"
  - In contrast, the reduction plans submitted for FY 2010 in September 2008 called for 5%,10% and 15% reductions plans based on a base that exempted 67% of agency GF budgets from initial consideration
  - For example, Direct Aid to K-12 was entirely excluded from across-the-board cuts, as was CSA. (These items were considered separately for targeted reductions)
  - The 15% reduction target totaled $850.5 million for FY 2010 after exemptions were added
- As a result, the 6% plan requested by Governor McDonnell represents a higher dollar value of reductions than did the 15% plans developed by Governor Kaine

# 2011 Session – *Why Restraint Should Be the Rule*

- Based on the budget outlook, mandatory spending requirements could consume additional revenue growth
  - Maintain structural balance -- avoid the “double-up to catch-up” spending that will drive out year costs
  - While the economy appears to be trending upward, prudence would dictate caution
- Out-year economic and revenue projections do not assume resumption of historic levels of revenue growth
- 2012-14 biennial budget pressures such as Medicaid, federal health care reform, mandatory deposits to the Revenue Stabilization Fund, VRS rate increases, K-12 , and public safety will consume new revenue growth
- Some of the actions used to address budgetary shortfalls during the recent recession were one-time in nature and may not be available in 2012-14 biennium

# Never Too Early To Look Ahead

A Sneak Peak At The 2012-14 Biennium

# Budget Outlook for the FY 2012-2014 Biennium

- What are known budget drivers?
- Can we achieve structural balance and un-do certain temporary savings actions?
- What is the potential impact of federal budget reductions on Virginia’s budget?

# 2012-14 Budget Drivers

- Development of the 2012-14 biennial budget will get underway in late Spring of 2011
- DPB develops the base budget, which equals FY 2012 appropriations, adjusted for one-time spending and annualized costs
- Base budget does not include: spending increases driven by state or federal law or high priority or discretionary spending
- Two primary types of budgetary pressures
  - Statutory: Driven by federal or state law i.e., Medicaid, SOQ, "Rainy Day" fund, adult and juvenile corrections, MR waivers, VRS, debt service, "599" funding, economic incentive payments
  - High Priority: Driven by historical commitments or enrollment demands i.e., higher education (in-state students, financial aid), indigent care at teaching hospitals

# Preliminary Budget Drivers for 2012-14

| | | $ in Millions | |
|---|---|---|---|
| | | **FY 13** | **FY 14** |
| Rainy Day Payment | | 0.0 | 222.1 |
| ***Judicial Department*** | | | |
| Criminal Fund Shortfall | | 8.5 | 8.5 |
| Unfreeze Judicial Vacancies | | 6.5 | 6.5 |
| ***Public Safety*** | | | |
| Inmate Medical Costs | | 9.0 | 9.0 |
| New Jail Staffing | Blue Ridge Regional Jail -- Amherst Expansion | 4.6 | 4.6 |
| 1:1,500 Staffing Ratio | | 0.7 | 0.7 |
| Potential Need to Close Additional Facility Due to Bed Lease Termination | | 10.3 | 0.0 |
| STARS Maintenance Costs | | 10.6 | 6.0 |
| Offender Reentry Initiatives | | 4.1 | 4.1 |
| HB 599 Payments | For each 1 % in revenue growth | 1.6 | 0 |
| ***Economic Development*** | | | |
| Various Research, Incentive, and Performance Grants Above Base | | 7.7 | 13.3 |
| ***K-12 Education*** | | | |
| Rebenchmarking Costs | | ? | ? |
| K-12 Sales Tax - Increased Based on Forecast | | ? | ? |
| Retirement - Funding for UAAL Based on June 2010 Valuation | | 175.8 | 175.8 |
| Teacher Retirement - Repayment Language | | 20.3 | 21.9 |
| Teacher OPEB Funding - Undo One Time Savings | | 12.4 | 12.4 |

# Preliminary Budget Drivers for 2012-14

| | | $ in Millions | |
|---|---|---|---|
| | | **FY 13** | **FY 14** |
| *Higher Education* | | | |
| Financial Aid | | 29.8 | 59.6 |
| Enrollment Growth | | 9.1 | 18.2 |
| O & M New Buildings | | 9.0 | 14.0 |
| *Health and Human Resources* | | | |
| Additional CSA Costs | | 19.0 | 20.0 |
| Medicaid Forecast | | 256.4 | 272.3 |
| Additional Medicaid Enrollees from Health Reform | | 0.0 | 13.3 |
| SVP - VCBR Facility Operations | | 20.5 | 24.5 |
| SVP - Facility Capital Planning | | 2.5 | 0.0 |
| SVP - Community | | 0.5 | 0.5 |
| DSS - Foster Care and Adoptions | | 5.5 | 6.1 |
| *Capital Outlay* | | | |
| Debt Service | Assumes Maint. Res, HEETF and Equipment | 3.0 | 2.7 |
| *Employee Benefit Changes* | | | |
| Retirement - Funding for UAAL Based on June 2010 Valuation | | 143.8 | 143.8 |
| Retirement - Repayment Language | | 23.9 | 25.6 |
| OPEB Funding - Undo One Time Savings | | 48.1 | 48.1 |
| State Employee Health Insurance | | 35.0 | 75.0 |
| | **Total - Indentified Issues** | **878.2** | **1,208.6** |

# Rainy Day Fund Requirements

- While there are no required Rainy Day Fund deposits in the current biennium, beginning in FY 2014 the amounts constitutionally required for deposit are substantial
- The initial estimates of the deposits developed by the Auditor of Public Accounts based on the current revenue forecast are as follows:
  - FY 2014: $222.1 million
  - FY 2015: $322.6 million
  - FY 2016: $261.5 million
  - FY 2017: $262.1 million
  - FY 2018: $97.3 million
- Further, because the deposit is made two years <u>following</u> a given fiscal year's close, the General Assembly has sometimes decided to make a pre-payment on known large deposits to off-set a single year hit
- Even after these deposits, balance in the fund (exclusive of any interest projections) would be $1.46 billion, or about $200 million below the cap on the fund based on the current 10% cap
  - If the cap is increased to 15% of the core revenues, the maximum would grow to $2.46 billion

# Certain Budget Actions Create A Structural Imbalance

- The current budget used a number of one-time actions and accounting strategies to help “manage” the budget problem
  - AST, dealer discount, delaying reimbursements to Medicaid providers, transfer of non-general fund balances and interest earnings
- While these actions helped manage the budget, their practice creates a structural imbalance
- Not all of these actions will be available in the 2012–14 biennium, which will have to be covered by new revenue growth or require additional budget reductions
- A number of accounting actions could continue to be used in order to manage the 2012-14 budget
  - In some cases, however, the General Assembly has already indicated their intent to reverse them

# Current Actions That Cannot Be Continued

| | | $ in Millions |
|---|---|---|
| *Unavailble Resources* | | |
| | State Corporation Commission -- One-Time Balances | 10.0 |
| | Unavailable CORIS Balances | 6.0 |
| | NGF Transfers for State Retirement | 65.7 |
| | NGF Transfers for State OPEB | 35.1 |
| | VITA Administrative Savings | 1.1 |
| | Pennsylvania Bed Lease | 10.0 |
| | DEQ Waste Tire Fund Transfer | 1.5 |
| | State Police Insurance Fraud Program Balances | 2.0 |
| | NGF Balances from DGS EVA Savings | 0.2 |
| | Durable Medical Equipment Savings | 1.7 |
| | NGF Virginia Power Rate Savings | 0.8 |
| | 9c Sinking Fund Balances | 0.2 |
| | | |
| | | |
| | **Total - Unavailable Resources** | **134.3** |

# Undoing Accounting Changes Would Require $442.1 Million

- The accelerated sales tax generated a one-time revenue gain in FY 2010; however, language in Chapter 874 calls for the “phase-out” of accelerated sales tax beginning in FY 2013
  - The impact of eliminating AST would be $230.7 million in FY 2013
  - To return to the bi-monthly remittance would require $140.3 million
  - To phase out the accelerated sales tax for all dealers with sales of $5.0 million or more would require $44.2 million or $62.9 million at the $10 million threshold
- Restoration of the compensation (dealer discount) paid to retailers who remit sales tax to the state would cost $49.1 million
  - Small retailers continue to receive a portion of their compensation in 2010-12
- The budgetary adjustment needed to DMAS budget in order to end the lag payments to Medicaid provider total $162.3 million

# Budget Management Strategies That Could Continue

| | $ in Millions |
|---|---|
| Dealer Discount | 60.9 |
| Accelerated Sales Tax | 230.7 |
| Lag in Payments to Medicaid Managed Care Organizations | 78.5 |
| Lag in Inpatient Hospital Quarterly Payments | 39.4 |
| Lag in Payments to Medicaid Providers | 32.8 |
| Lag in Payments to Federal Government | 11.6 |
| Higher Education Interest Earnings | 7.2 |
| Transfer of Health Department Trauma Fund to GF | 9.1 |
| Continuing to Capture NGF Portion of New Hire 5 percent Retirement | 8.4 |
| Continuing to Capture NGF Portion of New Hire ORP | 0.8 |
| Continuing Transfer of $2.00 from $6.25 for Life to GF and State Police | 10.5 |
| Continuing use of Tobacco Settlement Funds for FAMIS | 2.0 |
| | |
| **Total - Actions That Could Be Continued** | **491.9** |

# Potential Impact of Federal Budget Reductions On Virginia's Budget

# The Federal Budget and Its Impact on Virginia

- According to the Census Bureau's annual report on Federal Aid to States, on a per capita basis Virginia received <u>less</u> federal aid to state and local governments than any other state in the nation in FY 2009
- While this means that Virginia does not receive back a fair share of its federal tax dollars, because Virginia receives fewer federal grants than other states, it does insulate the Commonwealth to a certain extent because we are less dependent on federal funding to support our government programs
- If substantial across-the-board federal budget cuts occur, the greatest impact may not be at the programmatic level, but rather on a broader economic basis
    - Defense makes up a large portion of the Northern Virginia and Hampton Roads economies

# Reductions To Health and Human Resources Pose The Greatest Threat To Virginia's Budget

- In terms of direct impacts on state spending, Virginia is most vulnerable in the area of health and human resources
- Almost 60% of all funding grants to state and local governments are in the area of health and human resources, and 46% of the total is medical assistance programs
  - If the federal government reduced the match on the Medicaid program alone, every additional 1% Virginia had to match would cost about $70 million each year
  - Similarly, if TANF program block grant were reduced by 10%, Virginia would lose $16 million each year

# Impact of Potential Federal Budget Cuts On Transportation and Education

- Federal transportation funding makes up about 60% of Virginia's highway construction budget and averages (exclusive of ARRA) about $900 million a year
- If reductions in transportation funding were to occur, it most likely would take the form of an overall reduction in grants to the state
  - This would mean less money for construction projects but, unlike Medicaid, there is no implicit requirement that the state make up the difference
  - Alternatively, the federal government could consider increasing the state match on construction projects which generally is a 80/20 federal/state split
- In other areas of federal spending, much of the money flows directly to localities or to individuals
  - For example, federal K-12 funding flows to local governments according to federally driven formulas
  - Similarly, funding for higher education is limited to financial aid and to research funding which goes directly to the student or the institution
  - In neither case would the state be required to backfill any potential reductions

# Cuts In Defense Spending Would Have Broad Implications For Virginia's Economy

- While Virginia receives <u>less</u> federal aid to state and local governments than any other state in the nation Virginia is the number one recipient of federal procurement spending and federal defense spending on a per capita basis
  - Defense spending in Virginia totaled $6,713 per capita, 4.3 times the national average and accounted for 11.1% of all defense spending nationally
  - Federal procurement spending of all types in Virginia totaled $6,934 per capita, again 4.4 times the US per capita total
- Federal spending makes up 37% of the total economy in the greater Washington metropolitan area, with procurement alone accounting for 50% of economic activity
  - According to George Mason University's analysis of Secretary Gates' proposed defense procurement cuts, spending could decline by $9.5 billion in the DC region by 2012, and result in a reduction of 66,000 jobs
- Similarly, the Hampton Roads region is heavily dependent on military spending, with major bases throughout the region as well as military-related manufacturing.  Overall, the federal spending makes up about one-third of the Hampton Roads economy
  - Department of Defense spending in Hampton Roads increased in 2010 to an estimated $20 billion according to ODU's research
  - It has nearly doubled since 2000, growing at an average annual rate of 7% year
  - Like Northern Virginia, region would be heavily impacted by defense cut backs.  If Secretary Gates closes JFCOM, it is estimated to cost the region 10,000 jobs and $1.0 billion in lost income and ripple effects