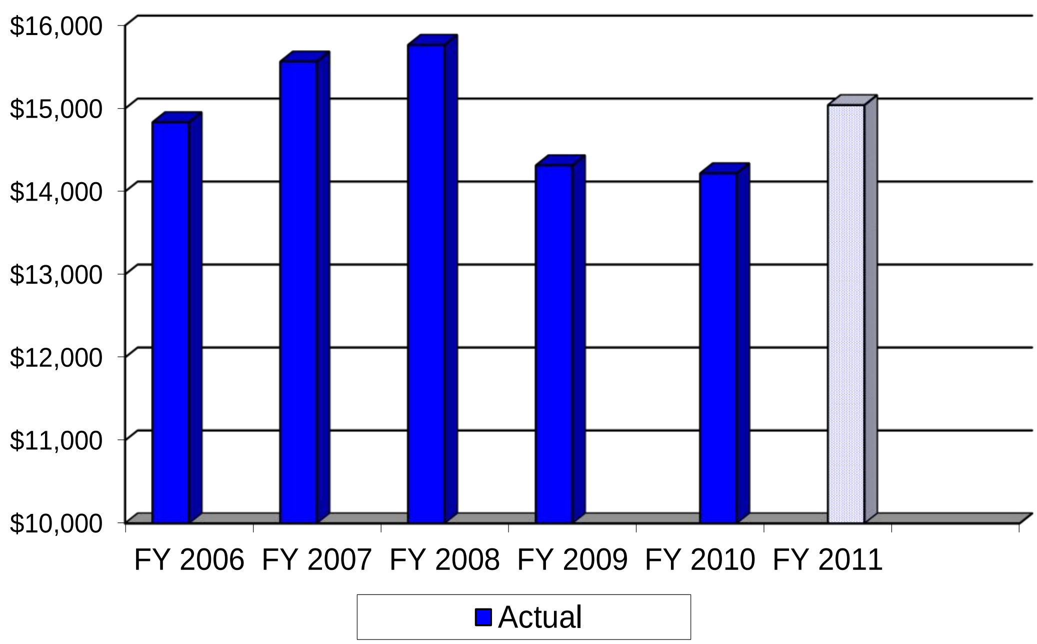
General Fund Revenue Collections for Fiscal Years 2011 and Preliminary Budget Outlook for 2012-14

FY 2011 General Fund Collections

Virginia finished fiscal year 2011 with general fund revenues (taxes and transfers) in excess of the forecast totaling $311.0 million. The total amount of tax revenue collections were $322.0 million over the estimate. However, this amount was offset by $11.1 million in transfers below the forecast, resulting in total general fund resources in excess of the forecast of $311.0 million. This amount does not reflect any unexpended agency general fund balances that may accrue to the general fund as of June 30, 2011. This amount will be identified when the Governor presents the year-end close in August.

Fiscal year 2011 marks the second year in a row that Virginia has exceeded its forecast for general fund revenues. However, it is important to note that in fiscal year 2010, actual revenue collections were still negative for the year-over-year comparison to FY 2009. Fiscal year 2011 however did post a positive growth rate over FY 2010, albeit revenue collections were still below the pre-recession level as indicated in the graph below.



Virginia experienced significant revenue growth in net individual income taxes (withholding, estimated payments and refunds), which accounted for two-thirds of the $322.0 million in excess general fund tax revenues. The strongest subcomponent was estimated payments, which exceeded the forecast by $110.2 million. Estimated payments account for about 14% of total general fund revenues and are among the most volatile revenue sources. Payroll withholding, which is about 60 percent of total general fund revenues, posted a gain of $60.2 million, growing 5% over the FY 2010 level, or about 0.7% above the forecasted growth rate.

Sales tax, which accounts for 20% of the general fund revenue, exceeded the forecast by $43.5 million; however, about $23.0 million is designated to go to the Transportation Trust Fund (TTF) as its portion of the excess revenues attributable to the accelerated sales tax collections (AST). Accounting for AST, tax amnesty and the dealer discount, overall sales tax collections grew 4.5%, below the economic based forecast of 4.8%. As a result, sales tax collections were within forecast.

It is also important to put the rate of growth for payroll withholding and sales tax into perspective compared to previous economic recoveries. For example, coming out of the 1991 and 2001 recession, withholding tax grew about 8% and 7.2%, respectively. Clearly the 5% growth experienced for FY 11 is not only anemic in comparison to previous recoveries, but is well below the long-term growth trend of 6.1%. The current rate of growth continues to reflect softness in the labor market and wages and salary growth.

Likewise sales tax growth in a normal economy is about 5.4% annually. Coming out of the two previous recessions, Virginia experienced a large surge in sales tax (7% and 14%, respectively) as consumers re-engaged. At this point, consumers still appear to be very cautious.

Corporate taxes, another volatile source, exceeded the forecast by $55.6 million, 2% ahead of the forecast.

In summary, it is important to provide some caution and clarity to the FY 2011 revenue performance. As noted, after adjusting the $311.0 million for the $23.0 million designated for transportation, general fund resources exceeded the forecast by $288.0 million. Approximately 58% of the excess ($165.8 million) came from the two most volatile sources -- corporate and estimated payments.

Commitments Against The Fiscal Year 2011 Revenues

While the Comptroller has not completed the official year-end close of the Commonwealth's books (August 18th Joint meeting), preliminary designations against the excess revenues are generally known. Of course these preliminary designations are subject to change based in part on agency year-end unexpended balances, which will impact the final amount that goes to the Water Quality Improvement Fund (WQIF), and the amount that goes to transportation as part of the undesignated balance (2/3 of any surplus). Finally, the amount of mandatory deposit to the Revenue Stabilization Fund (Rainy Day) must be certified by the Auditor of Public Accounts.

Based on a preliminary analysis of the required designations prepared by the Secretary of Finance, $229.9 million of the $311.0 million is offset by Constitutional and statutory requirements as follows:

- **Rainy Day Fund:** Based on the preliminary designation by the Secretary of Finance, $146.6 million of the FY 2011 excess revenue would be required to be deposited into the Rainy Day Fund. However, based on discussions with the Auditor, it would appear that the required amount will be slightly less after taking into account that $23.0 million of the sales tax revenue that is designated for transportation. The $23.0 million represents the TTF's share of the accelerated sales tax revenue collections. As such, this amount would not be included in the Rainy Day Fund calculation.

  It should be noted that in addition to the required deposit based on FY 2011 actual revenues, an additional deposit will be required based on FY 2012 revenues. The General Assembly set aside $114.0 million in the budget as a reserve against such required deposit. The amount required will be updated to reflect revisions to the FY 2012 revenue forecast in December. Of course the actual required deposit will be based on actual FY 2012 revenue collections.

- **Water Quality Improvement Fund (WQIF):** After meeting the requirements of the Rainy Day Fund, 10 percent of any excess revenues must be reserved by the Comptroller for deposit into the Water Quality Improvement Fund. Based on the preliminary designation, the WQIF will receive $32.2 million of the excess general fund tax revenues.

  The WQIF will also receive 10 percent of any year-end discretionary budget surplus from agency unexpended balances. This amount will be presented by the Governor at the August meeting.

- **Transportation's Share of Excess Revenue:** Approximately $23.0 million is designated for transportation representing the TTF's share of the July sales tax accelerated in June.

- **Disaster Relief:** Based on declarations by the Governor for disaster relief resulting from the tornados this past spring, approximately $4.3 million is designated for this purpose. Additional natural disaster designation may be included in the final report in August.

- **Contingent Appropriations**: The General Assembly made several contingent appropriations in Chapter 890 which total $23.8 million. These appropriations were for the following purposes:

  - $8.9 million for the required interest payment to the federal government for the Unemployment Insurance Trust Fund.

- $7.5 million for Base Realignment and Closure (BRAC (Oceana) in FY 2012.
- $7.4 million to supplement funding to sheriffs' offices in FY 2012.

- **Nonrecurring Expenditure Fund:** Any remaining revenues after all other designations are made are split two-thirds for transportation and one-third for nonrecurring expenditures. The Governor has indicated that after satisfying the transportation requirements, he would propose for consideration by the General Assembly that any remaining funds go to increase the VRS contribution rates in FY 2012.

  In adopting the budget, the General Assembly implemented a VRS rate increase in the fourth quarter of FY 2012. The Governor would propose that the rate increase go into effect earlier based on these excess funds.

Revenue Adjustments For Fiscal Year 2012

Fiscal year 2011 actual tax revenue collections form the base for the revenues for 2012. Because actual general fund tax revenues exceeded the forecast by $322.0 million, that amount ripples through to fiscal year 2012, and then is adjusted for the new growth rates.

The actual amount of additional revenue could be plus/minus depending on the recommended changes made to the economic forecast. The two largest factors that influence the forecast are wage and salary growth and job growth. These indicators are key to the economic model that drives income tax withholdings and sales tax collections. Both of these sources performed within forecast for FY 2011.

Another element that will influence the actual amount of additional revenue in FY 2012 hinges on whether the 2011 surplus was generated by economically driven factors or one-time events that are not sustainable, such as the increase in recordation taxes driven by home sales and some minor price appreciation or one-time capital gains that might be driving estimated payments. As noted above, estimated payments alone represented 37% of the excess revenue collections in FY 2011.

Revenues for 2012-14 Biennial Budget

Because of the potential upward adjustment to the FY 2012 revenue base, which forms the base for 2012-14 biennium, the amount of additional revenue in the next biennium could be greater than what was assumed in the previous out-year forecast.

The revenue forecasting process begins in October with the Joint Advisory Board of Economists (JABE), followed by the Governor's Advisory Council on Revenue Estimates (GACRE).

The forecast is driven primarily by the national economic outlook, adjusted for Virginia. The Global Insight economic model is used for the national forecast. The Virginia economic model incorporates Virginia data, including recommendations by JABE and GACRE. Key economic indicators in the Virginia model include:

- Job growth, by industry sector and region
- Personal income
- Wage and salary
- Migration
- Housing starts

<u>Factors That Can Impact The Economic Outlook For The 2012-14 Biennial Budget</u>

It is also important to recognize that housing and gas prices continue to undermine consumer confidence and consumer spending. Gas prices are up nearly $35 per barrel from a year ago - over a $1 per gallon. That removes a lot of discretionary dollars out of the economy. Global Insight calculates the impact for each 10 cent increase in gas at about $12 billion, so over $120 billion in discretionary spending is lost to higher fuel prices. Of course that does not take into account the rippling effect of higher prices on other goods. Back drop fuel prices with stagnate wages and anemic job growth and consumers are feeling stressed. Likewise, housing prices remain soft and will continue to remain soft as long as foreclosure activity exists and job growth is soft.

<u>Potential Impact From Federal Deficit Reduction Agreement</u>

Another important factor to consider is the impact of federal deficit reduction efforts making their way through Congress.

According to the Census Bureau's annual report on Federal Aid to States, on a per capita basis, Virginia received less 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, due to it receiving 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.

However, it is important to note that much of the federal 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.

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. As such, from Virginia's perspective, cuts in defense spending could potentially be damaging to our economy.

In terms of defense spending, Virginia ranks first in per capita spending. Overall total federal spending accounts for about 37% of the NOVA economy and about 34% of the Hampton Roads economy. The big question is how vulnerable is Virginia to cuts in defense? Much of the federal spending in NOVA is tied to out-sourcing as opposed to federal employment. In some respects this makes it more difficult for the federal government to pull back certain operations (think VITA). However, we could see procurement growth become flat to slightly negative. The loss of contracts for the shipyard would have a significant impact on Hampton Roads. Likewise, if Virginia were to lose certain military operations or an aircraft carrier we will experience job losses.

To put federal spending into perspective, 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.

<u>2012-14 Biennial Budget</u>

DPB develops the base budget, which equals FY 2012 appropriations, adjusted for one-time spending and annualized costs. Once the base budget is developed, adjustments are made based on caseload, and statutory requirements. Generally, there are two types of budgetary pressures:

- Statutory: Driven by federal or state law i.e., Medicaid, SOQ, "Rainy Day" fund, adult and juvenile corrections, VRS, debt service, "599" funding, economic incentive payments

- High Priority: Driven by historical commitments or enrollment demands i.e., MR waivers, higher education (in-state students, financial aid), indigent care at teaching hospitals

As the Governor begins developing his Executive budget for legislative consideration, agencies will be asked to submit their funding request for 2012-14. These requests will be forwarded to the Committee and reviewed by the staff as well. In addition, the Department of Education (DOE), Department of Medical Assistance Services (DMAS) and the Department of Corrections (DOC) will begin to develop their respective forecasts that will drive funding decisions in the new budget. The following are some of the major budget issues for the next biennium. The dollar estimates are very preliminary and are meant to give a sense of magnitude.

- **Required FY 2012 Rainy Day Payment:** The General Assembly set aside $114.0 million in the current budget against the preliminary FY 2012 required payment of $200.0 million. Depending on the revised revenue forecast for FY 2012, an additional amount will need to be set aside for deposit in FY 2014. If FY 2012 revenues grow 5%, the required deposit will be about $175 million (as opposed to the preliminary figure of $200.0 million), about $60.0 million more than was set aside by the General Assembly in the current budget. If revenues grow 6%, the required deposit would be about $240.0 million; about $125.0 million more than was set aside

- **SOQ Rebenchmarking**: Every two years, coinciding with the beginning of the biennial budget cycle, the funding model updates the cost of education based on the actual cost incurred by school divisions over the last two years. While we do not anticipate the cost of rebenchmarking to reach levels seen in the early 2000's, the Department of Education has provided a preliminary calculation of rebenchmarking at about $232.2 million. This number is driven primarily by increases in funded instructional salaries and non-personal support costs. Not factored into this preliminary cost are changes in 1) VRS contribution rates; 2) Average Daily Membership (ADM); 3) the Composite Index; and, 4) sales tax estimate that is distributed based on school age population. In addition to these factors, DOE has not taken into account participation rates that will impact the final cost of certain programs.

  While the actuary has not provided the recommended rates, preliminary VRS estimates suggest that an additional $200.0 million each year may be needed to fund the state's share of the teacher cost.

  In addition to the preliminary costs related to rebenchmarking, the Department of Education has also calculated updates to programs funded primarily through the Lottery Proceeds Fund. The initial update indicates that these programs could exceed the total available Lottery Proceeds by $86.5 million.

- **Medicaid Utilization and Inflation:** A very preliminary estimate is $806.0 million for Medicaid utilization, inflation and enrollment growth. DMAS and DPB will develop a consensus forecast by November 15th which will more precisely reflect Virginia's specific medical inflation costs, utilization of services and enrollment of individuals who meet current eligibility requirements as well as changes required by the new federal health care reform law.

- **VRS Rate Increase:** While the actuary has not provided the recommended rates, preliminary estimates suggest that an additional $175.0 million each year maybe be needed to fund the state's share of the state employee cost.

- **DOJ agreement and ID Waiting List:** The 2011 General Assembly set aside $30.0 million in a trust fund to begin to address the concerns raised by the Justice Department concerning the training centers and the ID waiting list. While we have not received any indication from the McDonnell administration on Virginia's response to the DOJ report, substantial action will most likely be required, although the agreement will be implemented over a multi-year period.

- **Other Health and Human Resource Issues:** Other funding issues driven by caseload factors include: Comprehensive Service Act, foster care, children's health insurance programs, and civil commitment of sexually violent predators.

Again, the respective agencies will be developing costs based on caseload and enrollment growth.

- **Higher Education Enrollment Growth and Base Adequacy:** The process of reviewing the 6-year financial plans is set to begin. However, based on the goals of the "Top Jobs" legislation adopted by the 2011 General Assembly, additional resources would be needed to accommodate additional in-state enrollment growth, the operating and maintenance needs of new facilities, and funding to keep tuition levels moderate.

- "**599" Aid to Localities Payments:** Payments for localities that receive "599" funding are tied to general fund revenue growth. For each 1% growth, approximately $2.0 million would be needed to fund the increase in payments.

- **Other budget issues are**: additional debt service payments for bonds that were authorized for new college buildings; an increase in health insurance premiums for state employees and rate changes for the group life insurance program; adjustment for per diem payments for local jails; and, additional deputy sheriffs for jails and law enforcement.

- **Accelerated Sales Tax:** The current budget reduced the amount of accelerated sales tax collections in fiscal year 2011 by approximately $46.0 million. This leaves approximately $190.0 million that is still accelerated. The General Assembly expressed its commitment to continue eliminating the AST in the 2012-14 biennium.

Conclusions

Clearly we face many challenges, both with continued uncertainty in our economic recovery, as well as continuing to unwind some of the balancing strategies utilized in the current budget such as VRS and AST. However, the fact remains that many of the hard decisions previously made by the General Assembly and Governors Kaine and McDonnell have put Virginia's finances in a much better posture than many other states.

In a recent paper prepared by the Commonwealth Institute, they indicated that the state could face a budget shortfall of $800 million in the next biennium. The Commonwealth Institute is a progressive think tank that fosters spending on low and moderate income persons, with specific spending for education and human service related programs. Key to their analysis is an assumption that the General Assembly will restore cuts to programs in which federal stimulus money (ARRA) was used to backfill.

For example, the report assumes that revenue growth in FY 2012 would need to grow by 9% to make up for the loss of federal Recovery Act funding (ARRA). For the most part ARRA dollars were budgeted in FY 2011, although school divisions could carry the federal dollars forward for use in FY 2012. It should also be noted that in utilizing ARRA dollars an implicit policy assumption was made that general fund reductions would be made and that the ARRA dollars would be utilized, primarily in K-12 and Higher Education, to ease the state cuts, but that the state would not be responsible for backing filling the ARRA funds in the future.

In achieving budget reductions in higher education, for the most part colleges raised tuition to mitigate the eventual loss of ARRA dollars. While tuition did not totally offset the ARRA funds, the 2011 General Assembly did invest nearly $100 million in general fund to higher education, which would be reflected in their FY 2012 base.

With regard to state spending reductions in K-12, much of the spending reductions were coupled with policy changes designed to align the state's K-12 funding within the long-term general fund revenues. For example, Governor Kaine proposed and the General Assembly adopted a ratio on the number of support personnel to instruction personnel. Likewise, many non-SOQ funded programs were moved from the general fund into the Lottery fund, thereby limiting the growth of these programs to the growth in Lottery proceeds.

The General Assembly will need to continue showing restraint in developing the 2012-14 budget, and recognize that restoring many of the previously approved budget cuts will not be possible. By focusing our attention on restoring funding to the VRS, coupled with limiting the growth of existing programs and avoiding the start-up of new programs, Virginia will achieve a balanced budget within the revenue growth that we expect to accomplish over the next three fiscal years.