The Economic and Budgetary Outlook for Virginia…More of the Same, With Some Added Drama?

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House Appropriations Committee
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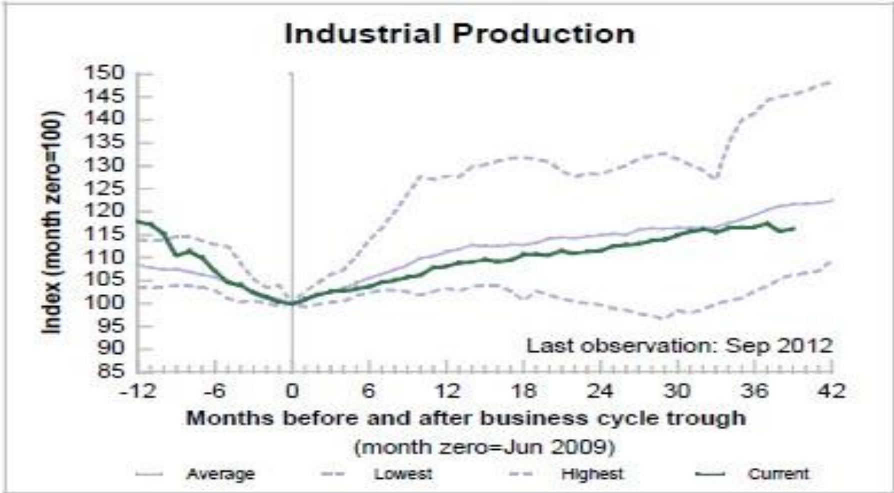
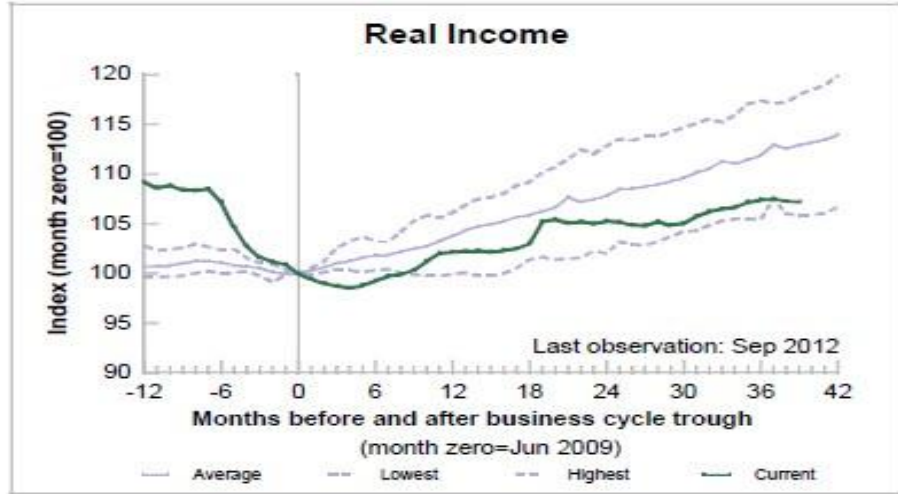
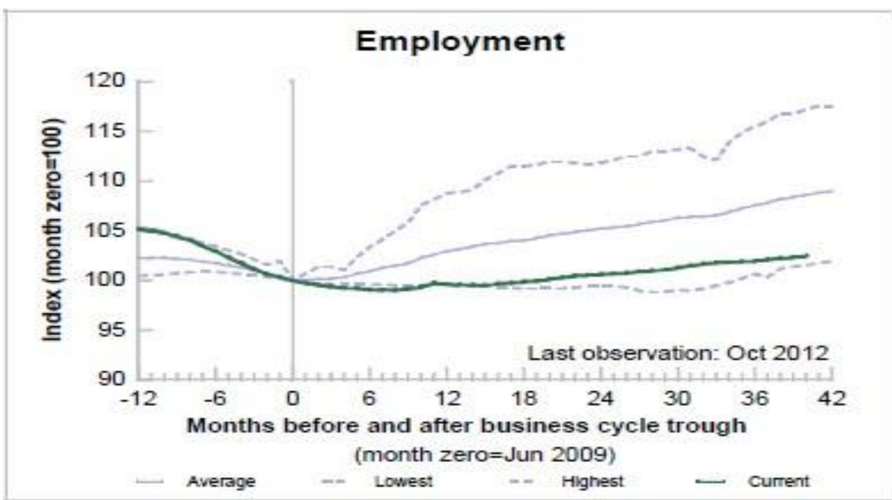
The Recovery Has Zig-Zagged Since the "Official" End of the Recession

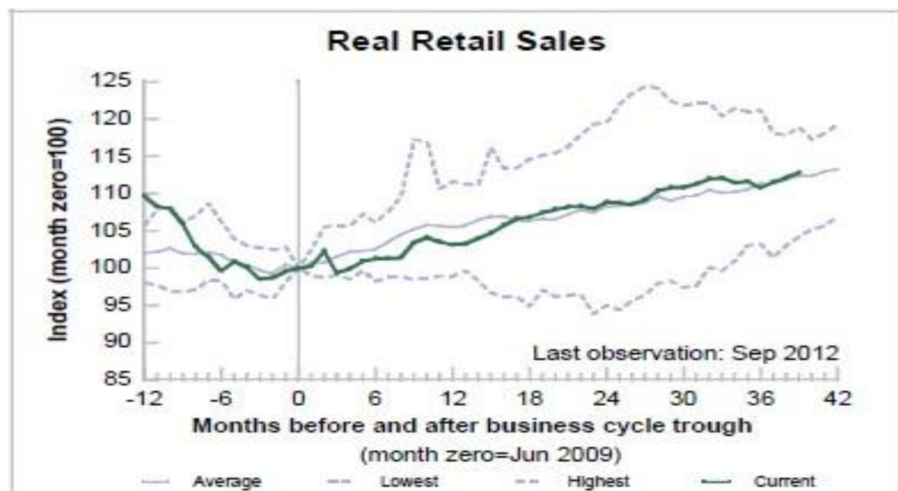
- The U.S. economy is growing at such a slow pace that the lack of job creation makes it "feel" as if the economy is in a recession even though the economy is still advancing
  - GDP growth is at a level equal to recovery from the worst recession
- Nationally, unemployment remains elevated at 7.9%
- Companies continue to hoard cash, in part because of the uncertain economic recovery and tax policies in Washington, along with the fear that they won't have access to credit
- Manufacturing output has weakened, as exports orders have slowed, as Europe continues to deal with their fiscal/debt problems
- Consumers remain cautious, spending primarily on replacement items, such as autos
- While the housing sector may celebrate small victories such as rising sales and an increase in housing starts, the overall economy continues to struggle with unemployment and fragile consumer spending

How Has The U.S. Economy Fared Since The “Official” End of The Recession?









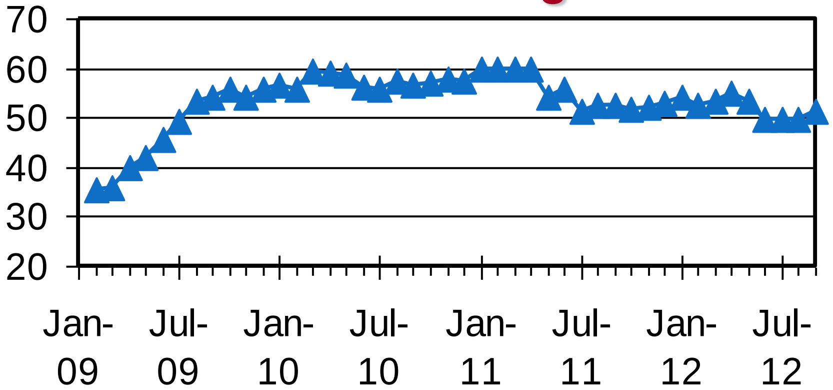
Data last updated 2012-11-02.

What Are The Key National Indicators Saying?

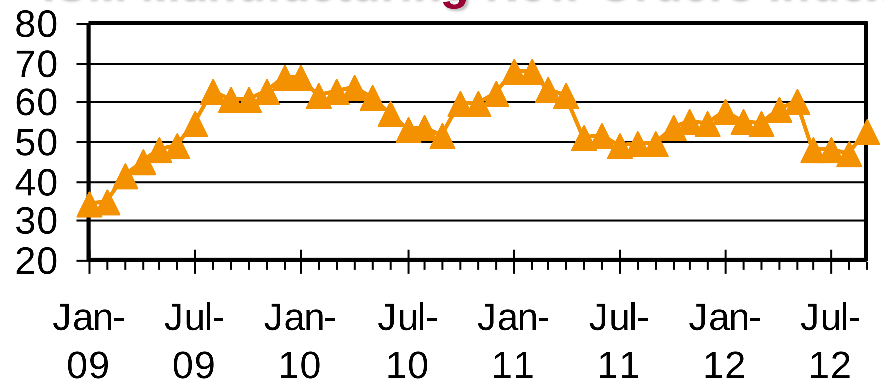
- ISM *Report On Business* shows the manufacturing sector expanded in October following 3 months of slight contraction, and the overall economy grew for the 41st consecutive month
- New Orders Index registered 54.2% in October, which is an increase of 7.1% when compared to the August reading of 47.1%
- Manpower's 2012 Q4 survey of 18,000 firms reveals 17% of employers expect to add workers, 9% expect to contract, and 72% of the firms plan no change in hiring
  - All four U.S. regions surveyed report a positive Net Employment Outlook, with the South region reporting the strongest outlook at +12%
- Year-to-date mass layoff events and initial unemployment claims both recorded their lowest figures for a January-August period since 2007

With 8 of 18 Manufacturing Industries Reporting Growth in October, Manufacturing Sector Expands for 41th Consecutive Month…Albeit The Indexes Have Slipped Towards Breakeven

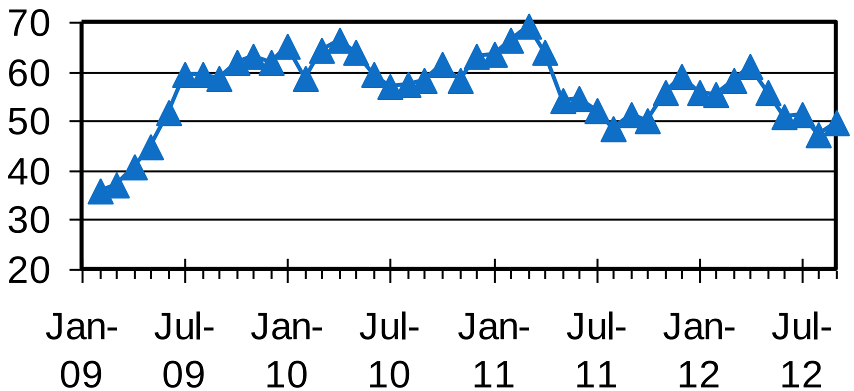
ISM Manufacturing Index



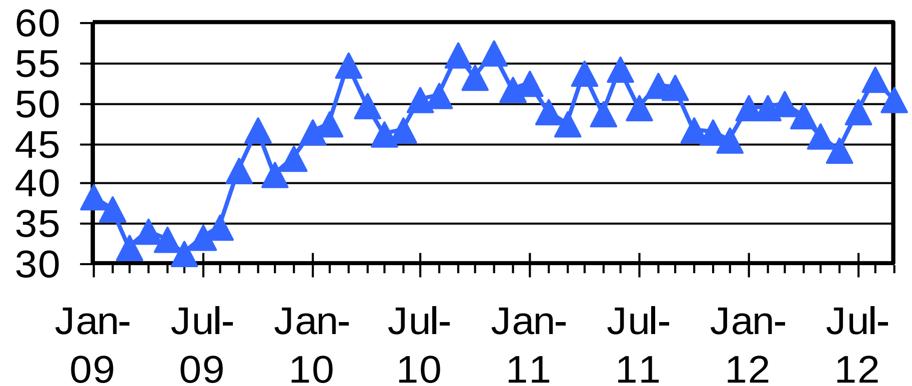
ISM Manufacturing New Orders Index



ISM Manufacturing Production Index

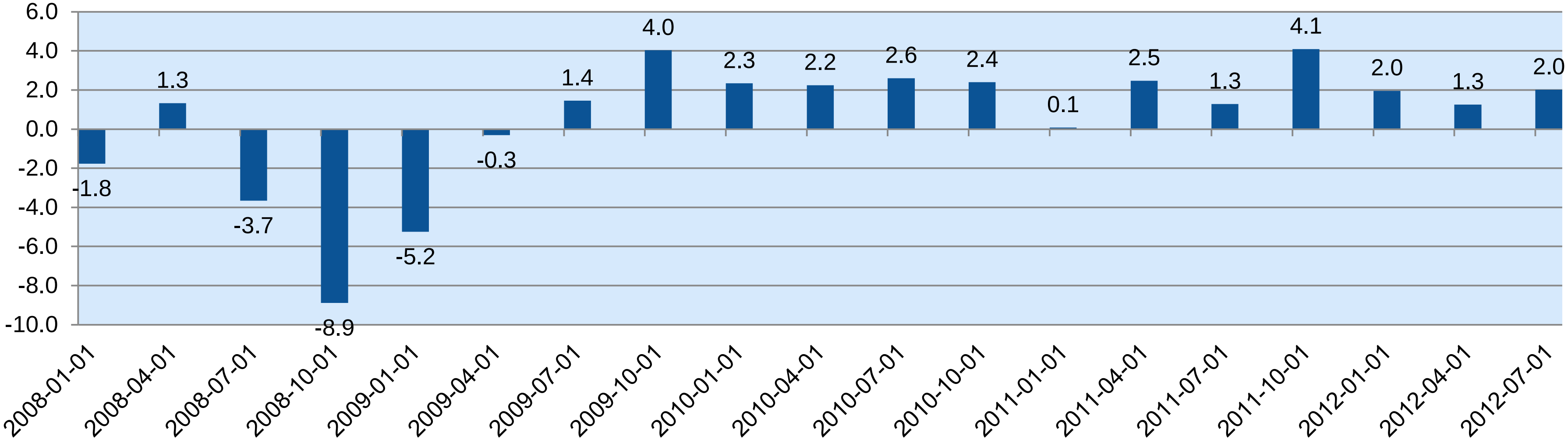


ISM Manufacturing Inventories Index



All indicators are diffusion indexes

13 Consecutive Quarters of Positive GDP, But Recent Data Indicates A Slowing Economy



- After dipping in the second quarter, the third quarter GDP increase reflects positive contributions from personal consumption, residential fixed investment, and **federal defense spending**. Negative contributions include exports, inventory, nonresidential fixed investment, and state and local government spending
- **Exports growth has dropped to a single digit pace**, reflecting the slowdown in Europe and Asia
- The deceleration in business investment also reflects the continued uncertainty in Washington over fiscal policy

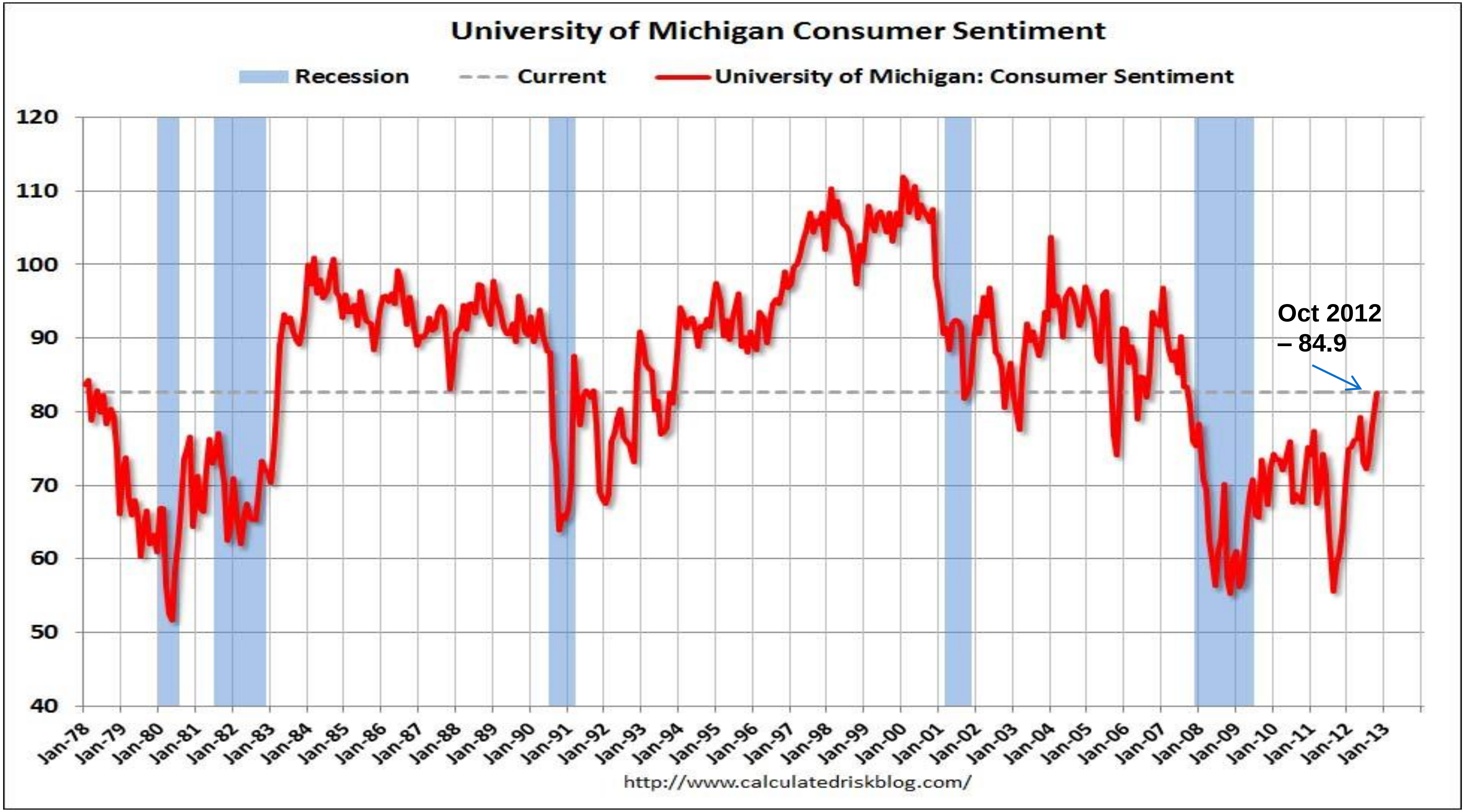
Is The Consumer Really Feeling Better Or Do They Still Remain Cautious?

October's Consumer Sentiment Reveals Continued Concerns With Employment, but Optimism with Gas Prices and Housing

Signs of Improving Consumer Confidence?

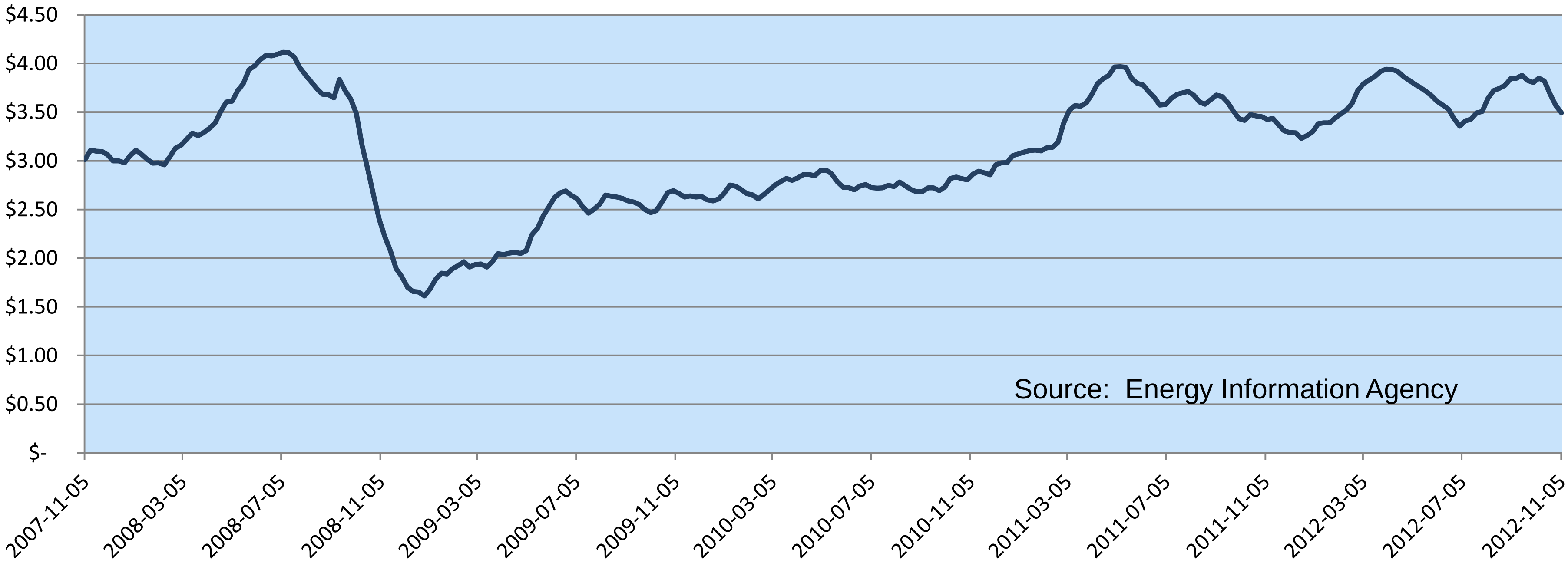
- Consumers were more confident about their economic prospects in October than any other time during the past five years
  - Consumer sentiment has been buoyed by positive news on housing, and the 40 cents a gallon drop in gas prices since mid-September
  - But there is continued uncertainty about employment, with 50.3% of survey respondents saying that jobs are “not so plentiful” and 39.4% saying jobs are “hard to get”
- National Retail Federation’s forecast for the upcoming holiday season is 4.1% growth
- However, when the economy is growing at a good clip, confidence readings are at least 90 and we still aren’t there
  - The last time the confidence gauge reached above 90 was in December 2007
  - This could mean the surge in optimism is vulnerable to reversal

Consumer Sentiment Nearing Pre-Recession Levels But A Reading Over 90 Would Signal A Recovery

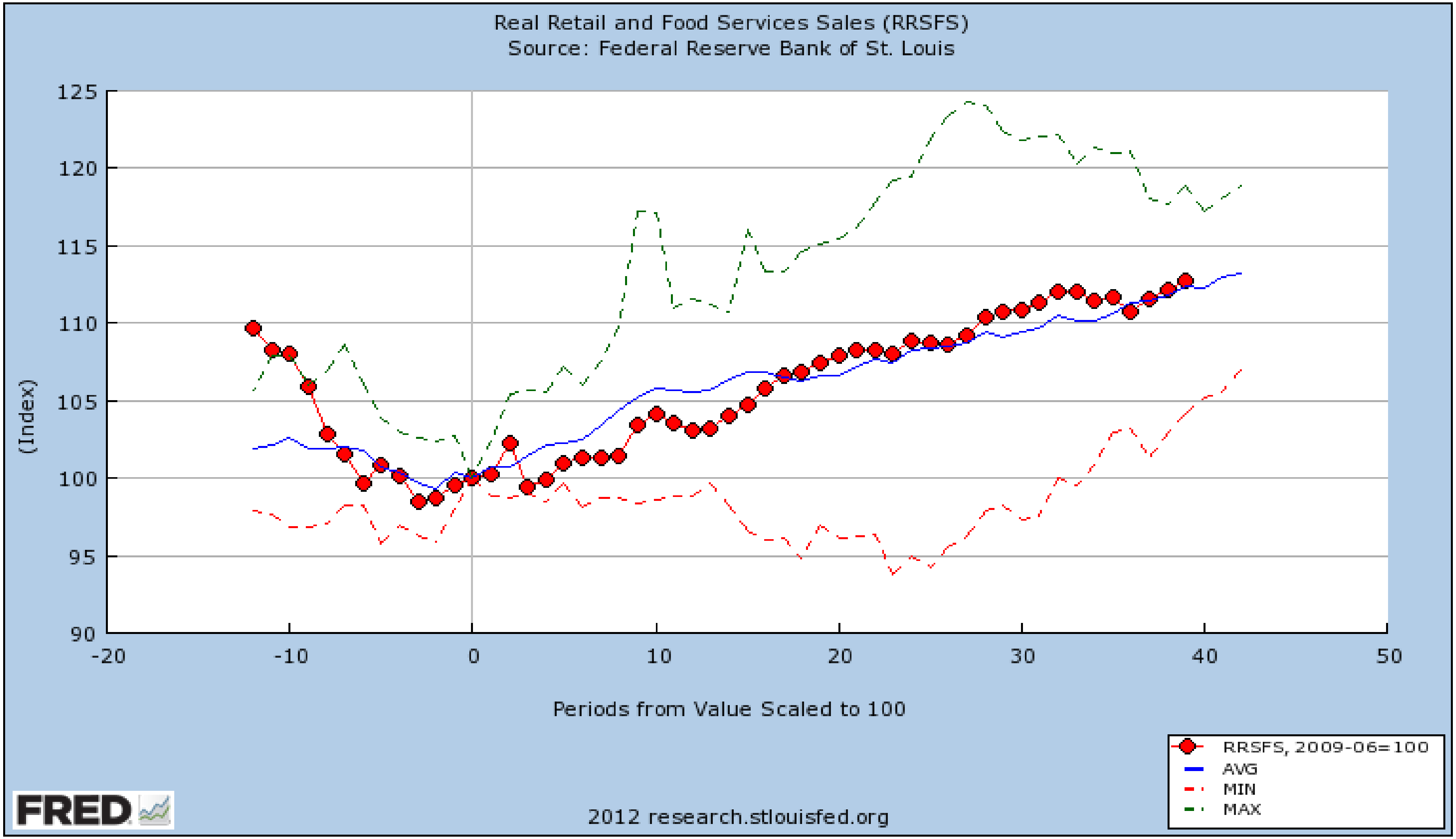


Gasoline Prices Impact Discretionary Spending

- In July 2008, the price per barrel of oil reached its all time inflation-adjusted high -- previous high was in 1981
- In March 2012, average price per gallon was $3.92, just below the 2008 high of $4.10 per gallon
- While oil prices are down $0.43 from May, gas is still $0.26 higher than last December
- Nationally, every 10 cent increase in gas costs consumers $12 billion annually and a $1.00 increase in gas prices will cost the average auto owner $600 a year (per car)



Consumer Spending Took Longer To Recover But Trend is Now on Par With Previous Recoveries

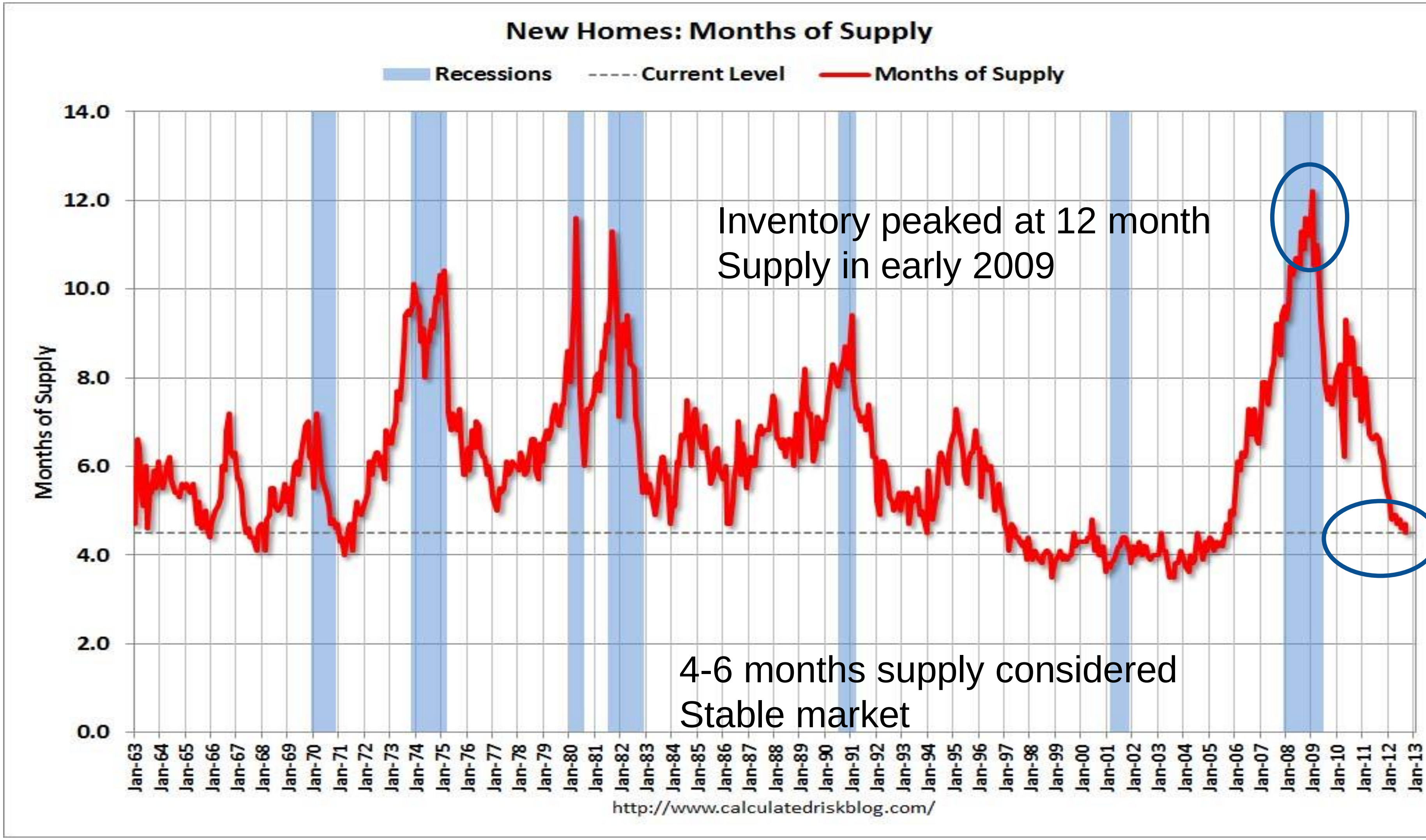


Housing: Finally a Contributor to Growth

Housing: Finally A Contributor to Growth

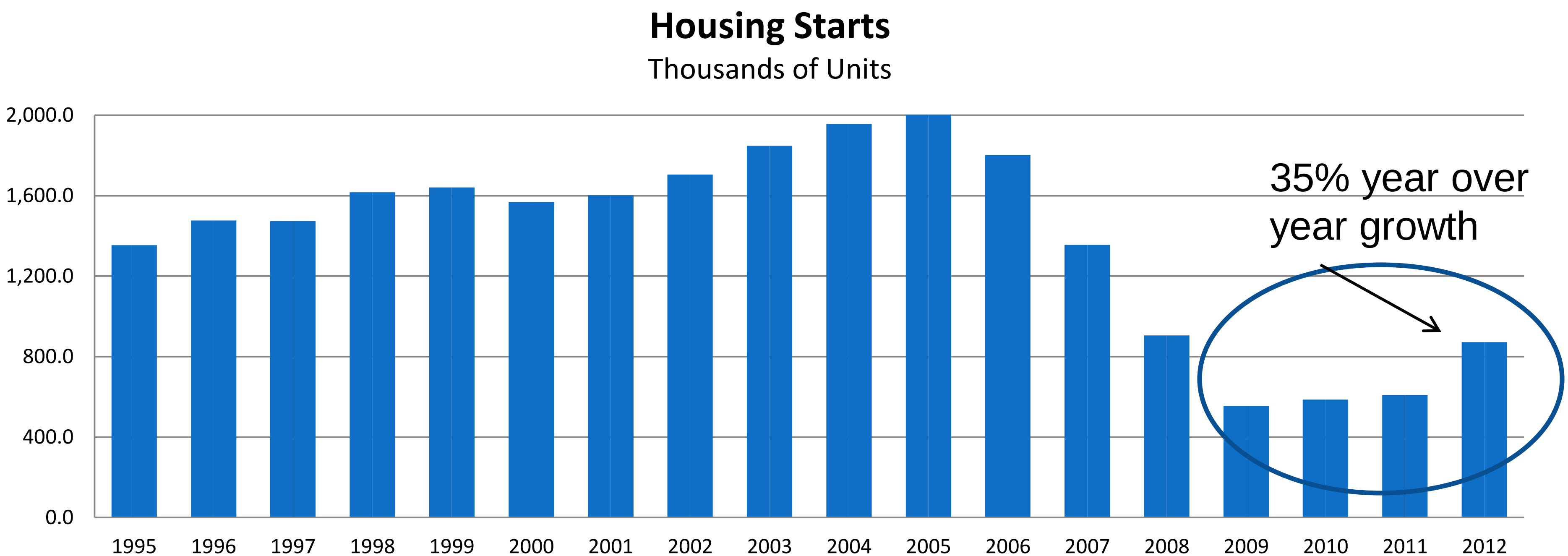
- U.S. Census Bureau data indicates new sale volumes increased 38% on a year-over-year basis in September 2012
- National Association of Realtors predicting – optimistically – 50% growth in housing starts next year
- The 3rd quarter 2012 advance GDP report shows that residential investment's share of GDP has increased about 10% over the past year
- Housing inventory levels have returned to healthy levels – 5 months supply
- Average pricing has begun to increase albeit at low levels in most markets
  - Home prices nationwide increased year-over-year by 5% in September, the biggest increase since July 2006 and the seventh consecutive monthly increase in home prices
  - Price index still off 27% from the peak – but is up 9.7% from the post-bubble low
- In Virginia, recordation tax receipts reflect this, having grown 10.5% in FY 2012, with a 4th quarter growth of 20.2% due to improving markets and low interest rates

Housing Inventory at Healthy Levels



Source: U.S. Bureau of Census

National Homebuilding Trends



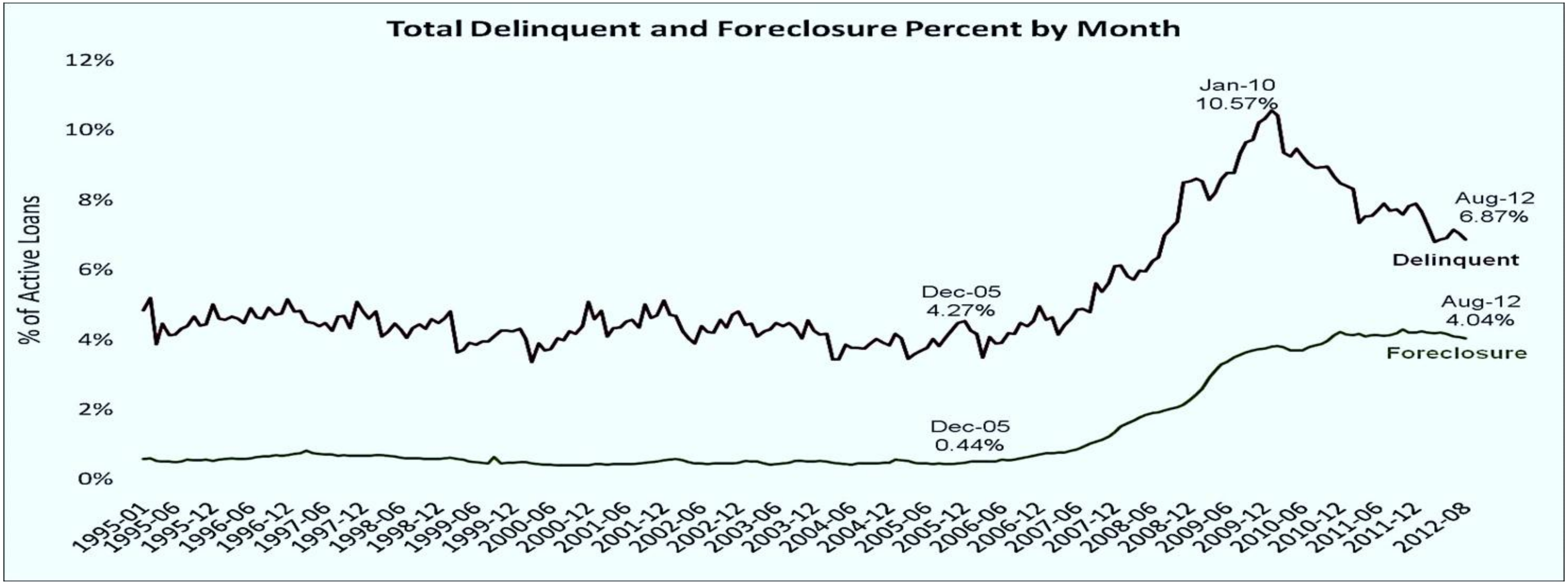
- US Bureau of Census data on housing starts show they reached a bottom in 2009 at 554,000
- Growth remained very modest in 2010 and 2011 despite repeated predictions that improvement was just around the corner
- Housing starts in September 2012 were growing at a seasonally adjusted annual rate of 872,000 – 15% above the August rate and 35% above the September 2011 rate

Source: U.S. Department of Commerce, October 2012

Continued Constraints on Housing Market

- Although foreclosure rates are dropping, they are still 50% above normal levels
- Negative equity and near-negative equity mortgages still account for 27% of all residential properties
- Continued tight lending standards
  - The average credit score for loans remains more than 50 points higher than in 2006
- Appraisal issues
  - By their very nature, appraisals lag market conditions
  - Lenders often requiring 8-10 comps which tends to result in including distressed sales, which pulls down overall values
- Shadow inventory estimated between 2.3 – 3.2 million
- But…within each of these constraints we are seeing improvement

Foreclosures Declining

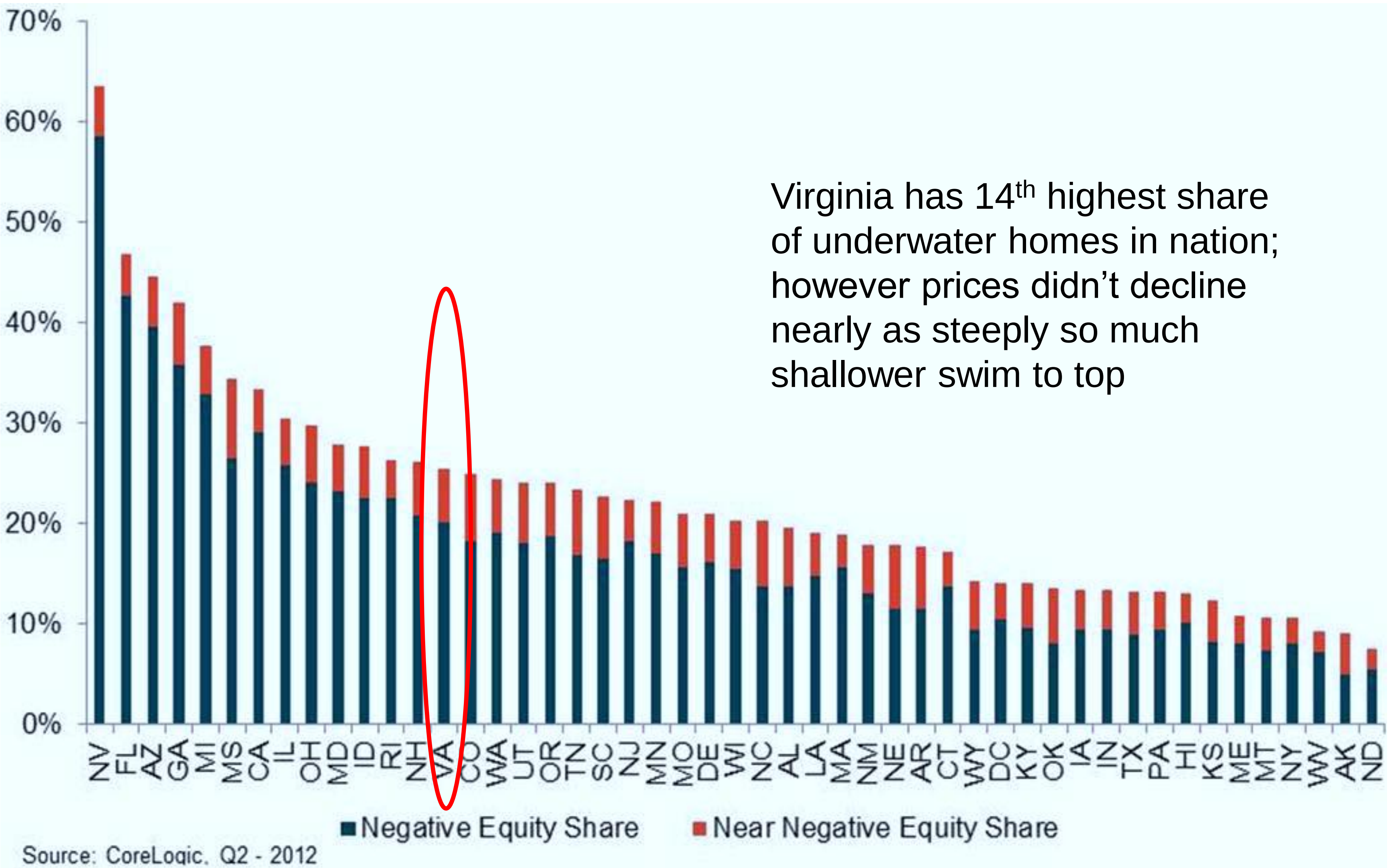


- According to Lender Processing Services, 6.87% of mortgages were delinquent in August, a decline of 13% compared to a year ago
- Foreclosure rates were down only 2.0%, but foreclosure starts were down 18.5%
  - Indicative of length of process and caution with which banks are moving forward at this time
- Foreclosure listings are down 47% from their October 2009 peak, and are down 23% from one year ago - Banks selling more homes to investors at trustee sales and approving more short sales

Is the Water Receding?

- CoreLogic reported just over 22%, or 10.8 million, of properties with a mortgage were underwater in the Q2 2012
  - 5 states account for more than 34% of all negative equity in the U.S.
  - However, the situation continues to improve with more than 1.3 million households regaining a positive equity position since the beginning of the year
  - Shift caused by, lower inventory and reduced REO sales which have helped increase prices, as well as more flexible refinancings
- As of Q2 2012, 1.8 million borrowers were only 5% underwater. If home prices continue increasing, these borrowers could quickly move out of a negative equity position
  - 40% of those underwater owe between 1% and 20% more than their home is worth
  - 91% of those underwater are current on their mortgages and continue to make payments

National Distribution of Negative Equity

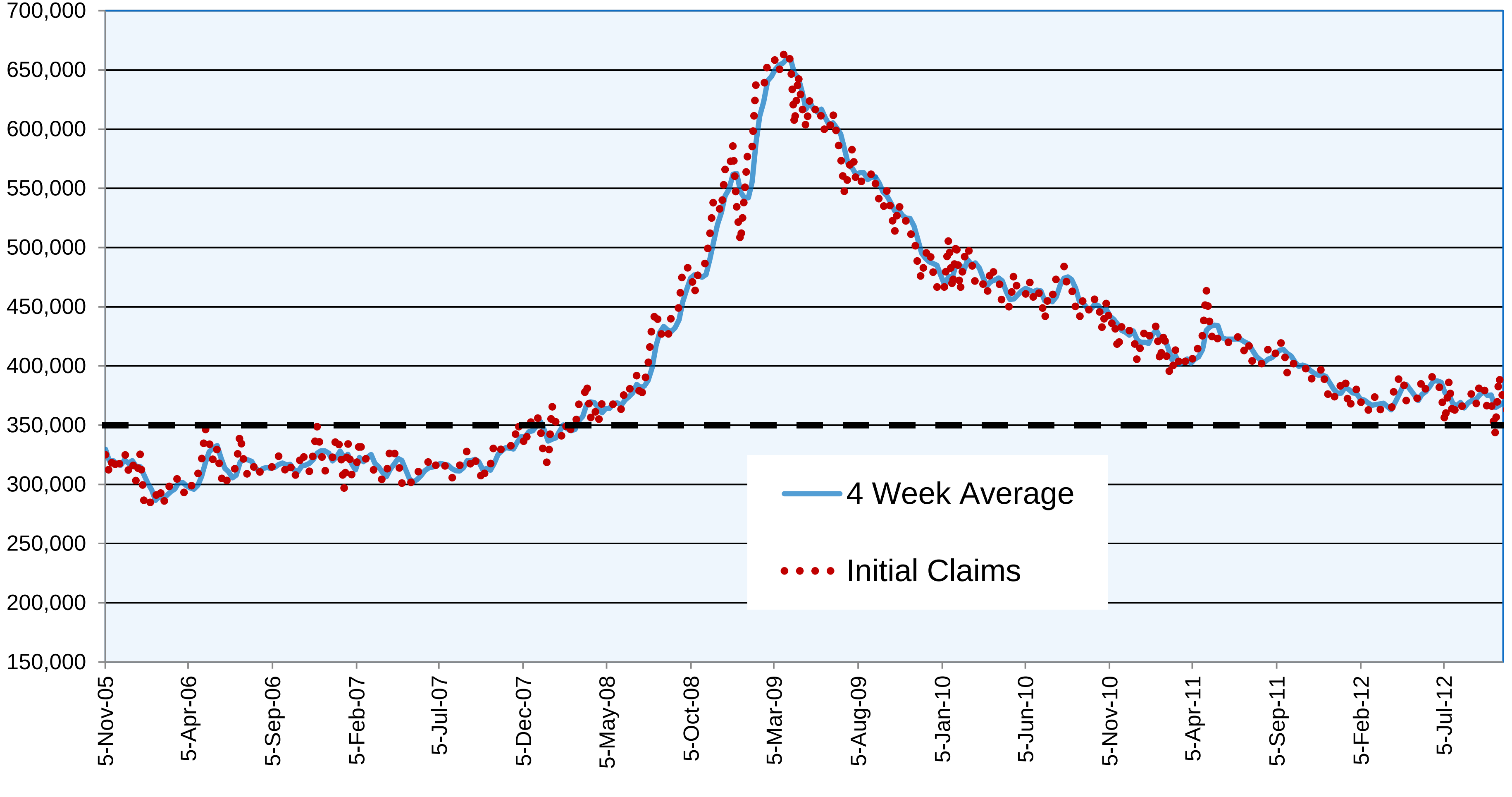


Virginia has 14th highest share of underwater homes in nation; however prices didn't decline nearly as steeply so much shallower swim to top

National Employment and Why Virginia Is Underperforming The Nation

Northern Virginia Continues to Lead in Job Growth, But Signs Point to a Slow Down

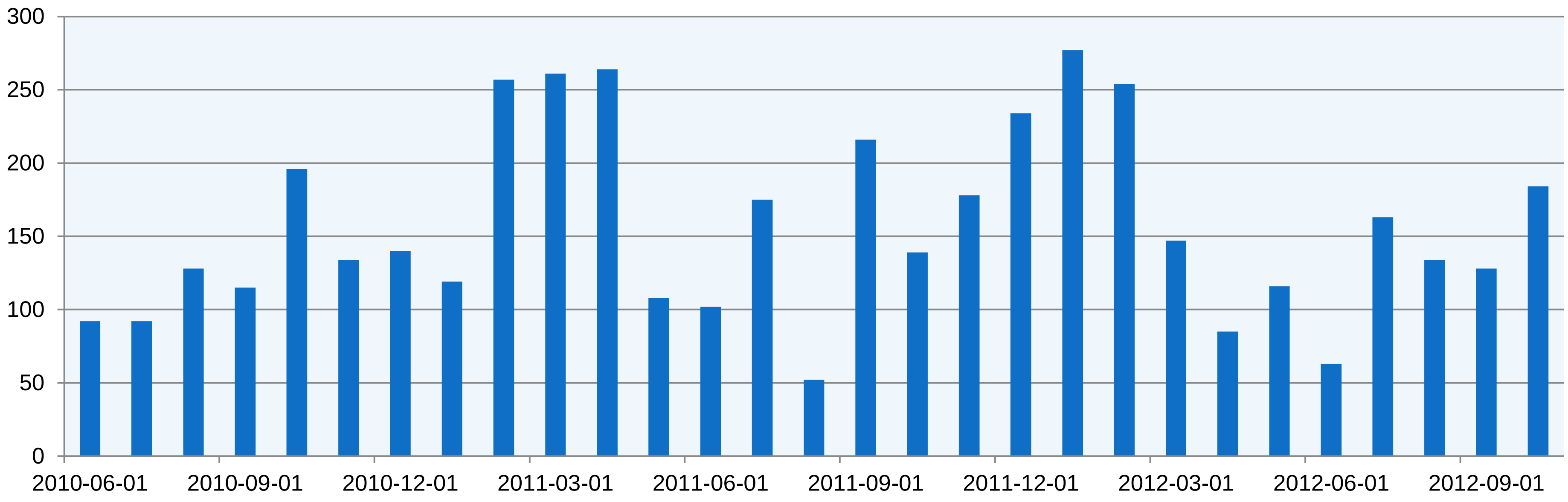
Initial Unemployment Claims… Receding From Their Peak, But Economists Are Looking For A Reading Of 350,000 and Below



Private Sector Employment -- The Silver Lining

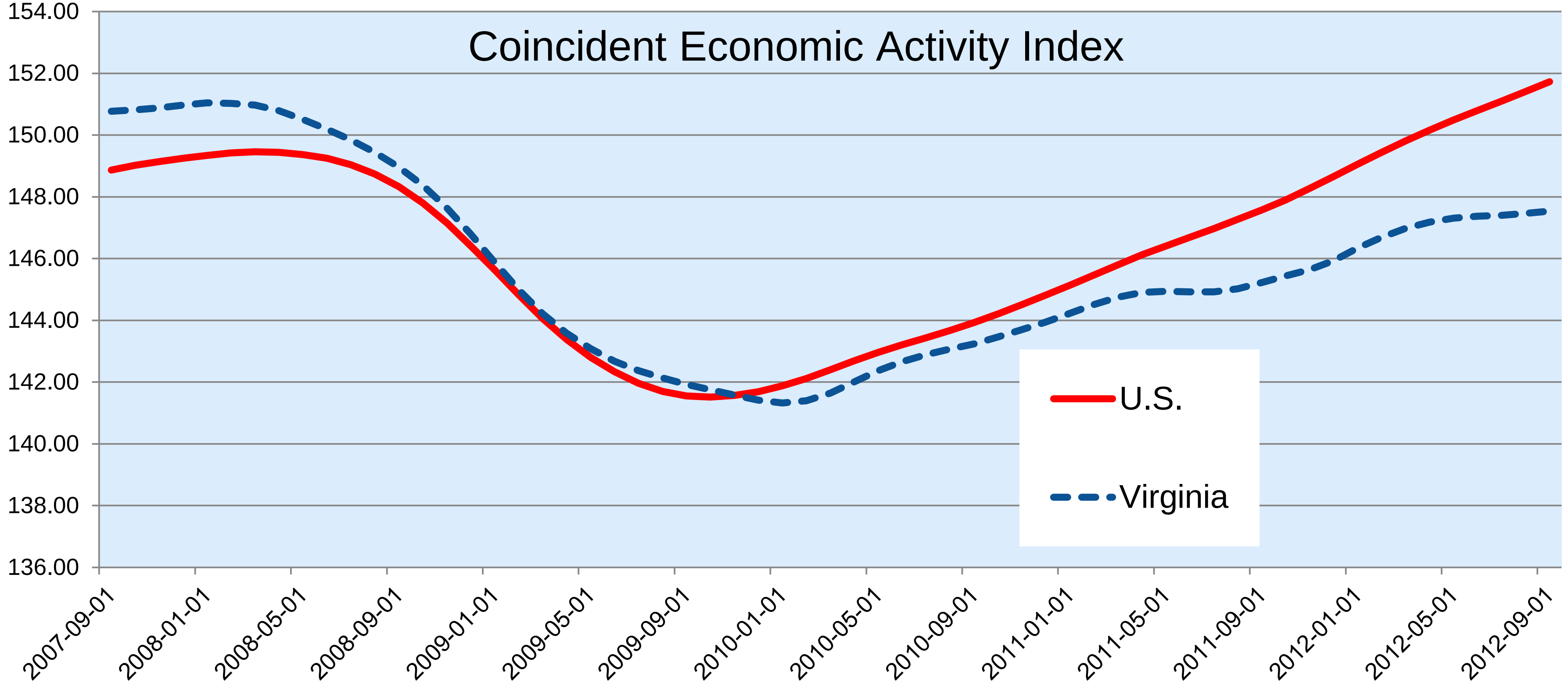
Monthly Job Growth (in thousands)

- A total of 7.8 million jobs were lost during the recession and 3.7 million have been recovered
- But, in the last 6 months average total job growth has been 137,000/month compared to 188,000/month over the previous 6 months
  - 125,000 jobs per month required just to absorb new entrants to the labor market. At the current rate, it will take approximately 3 years to recover the jobs lost
- U.S. private sector employment gains have occurred for 32 consecutive months – average about 155,000 per month -- Added 5.1 million jobs over that period of time



How Is Virginia's Employment Faring?

Based on Leading Indicators, Virginia, Which Typically Out Performs the Nation, Began to Slow Down in 2010

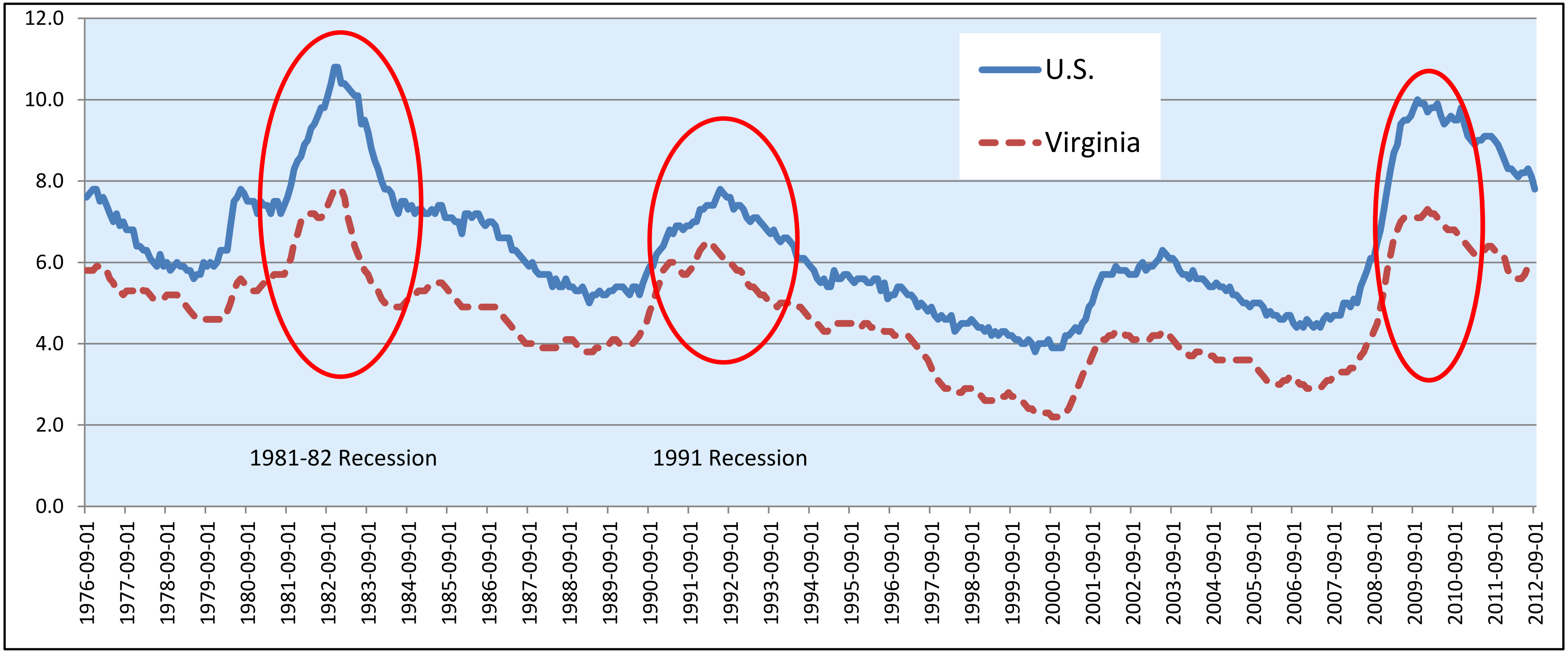


The Coincident Economic Activity Index includes four indicators: nonfarm payroll employment, the unemployment rate, average hours worked in manufacturing, and wages and salaries.

Source: Federal Reserve Bank of Philadelphia.

Virginia's Unemployment Rate in Perspective

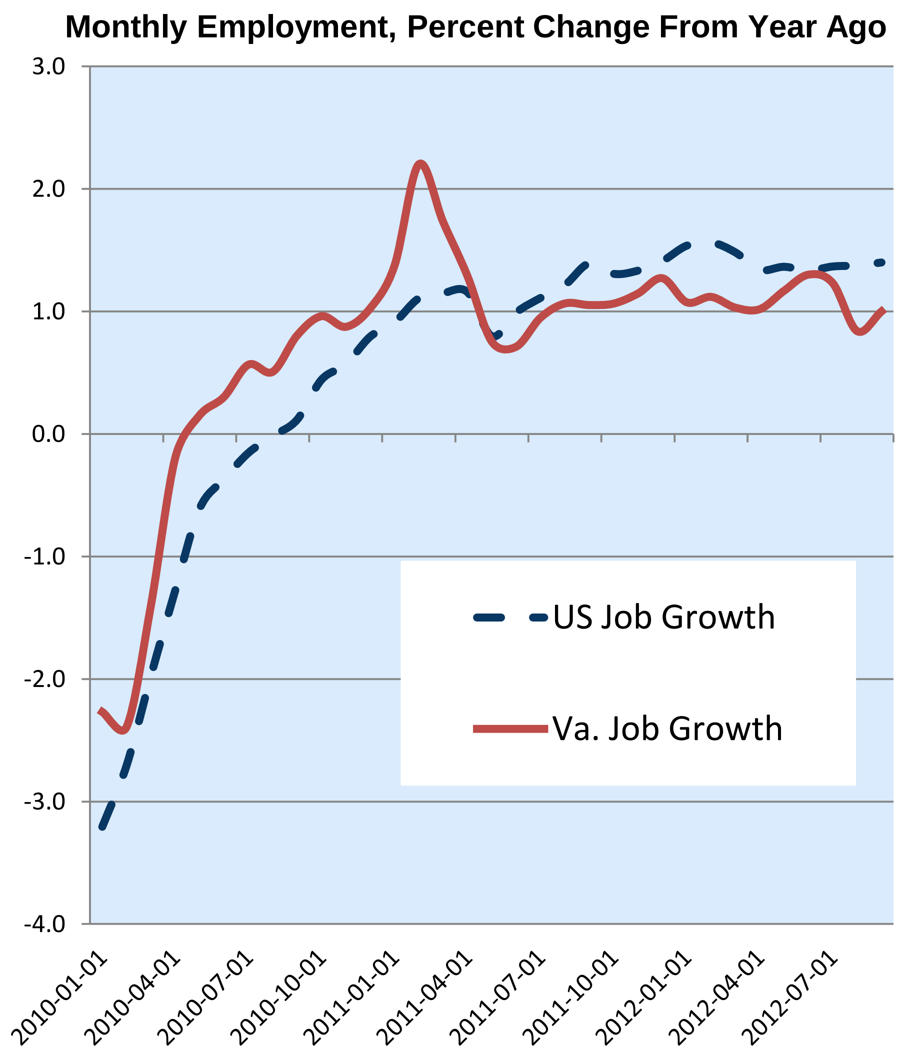
- At 5.9%, Virginia's unemployment rate is 25% lower than the national unemployment rate of 7.9%
- However, while the nation's rate has fallen 2.1% from its peak of 10% in October 2009, Virginia's rate has fallen 1.4% from its peak of 7.3% in January 2010



Source: Bureau of Labor Statistics.

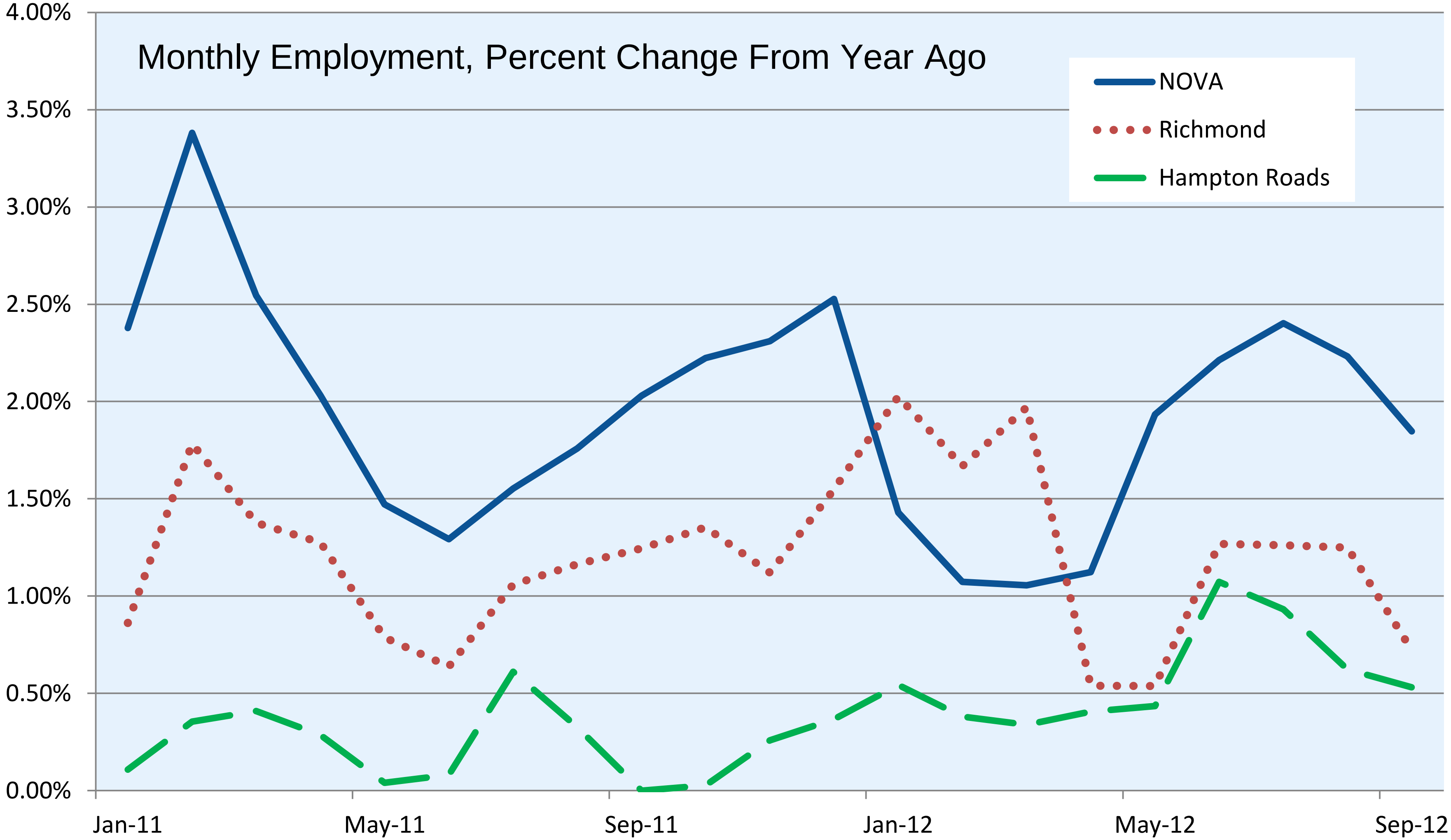
Virginia's Job Growth Has Under Performed The Nation Since May 2011 – Why?

- Virginia's annual employment growth rate was 1.0% for the first 3 months of FY 2013 – in-line with the "official" forecast
- Initially after the recession, Virginia's economy out-performed the U.S. However, since May 2011, Virginia's rate of job growth has been below the U.S. by nearly 3/10 of 1%
- Virginia's job losses were not as severe as the nation as a whole -- Virginia's job loss equaled about 4.9% of total employment versus 6.3% nationally
- Nationally, since May 2012, 37.4% of jobs have been recovered versus 52% in Virginia



Source: Bureau of Labor Statistics.

Job Growth Has Slowed In All 3 Major MSA's

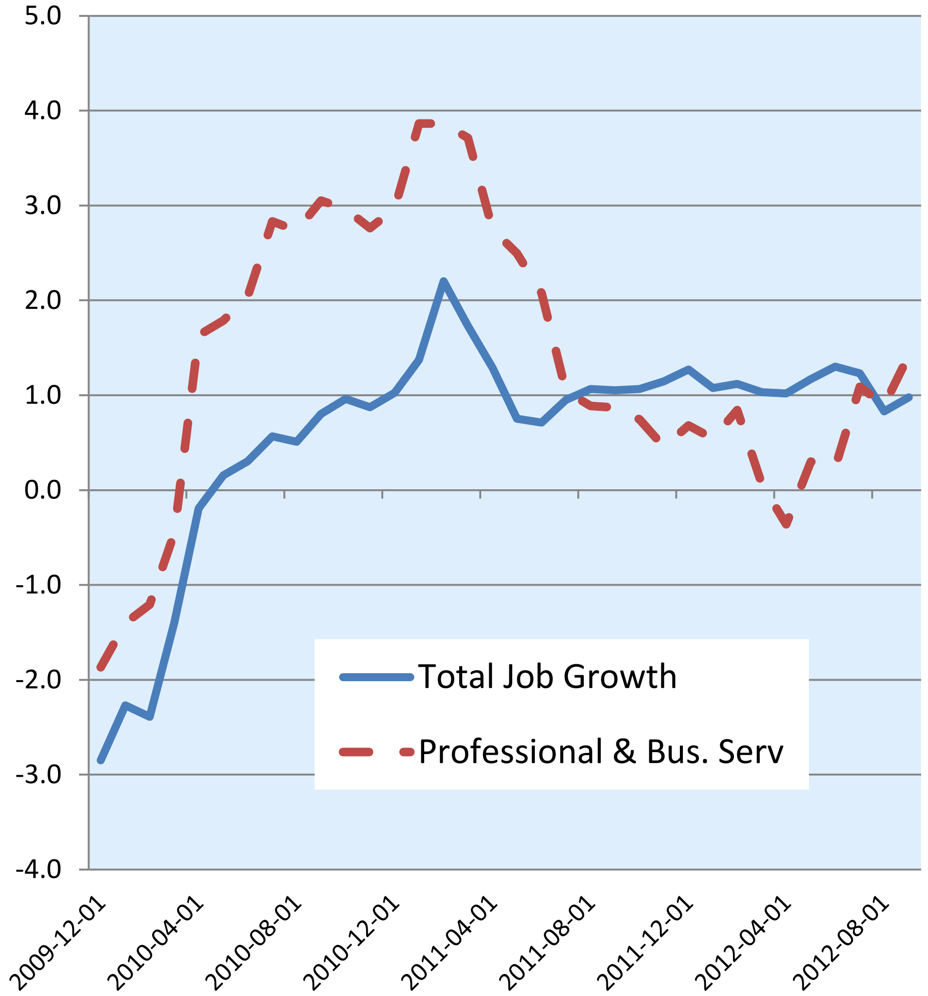


Source: Virginia Employment Commission.

Professional & Business Services, Grew Nearly 3% in FY 2011, But Less Than 1% in FY 2012

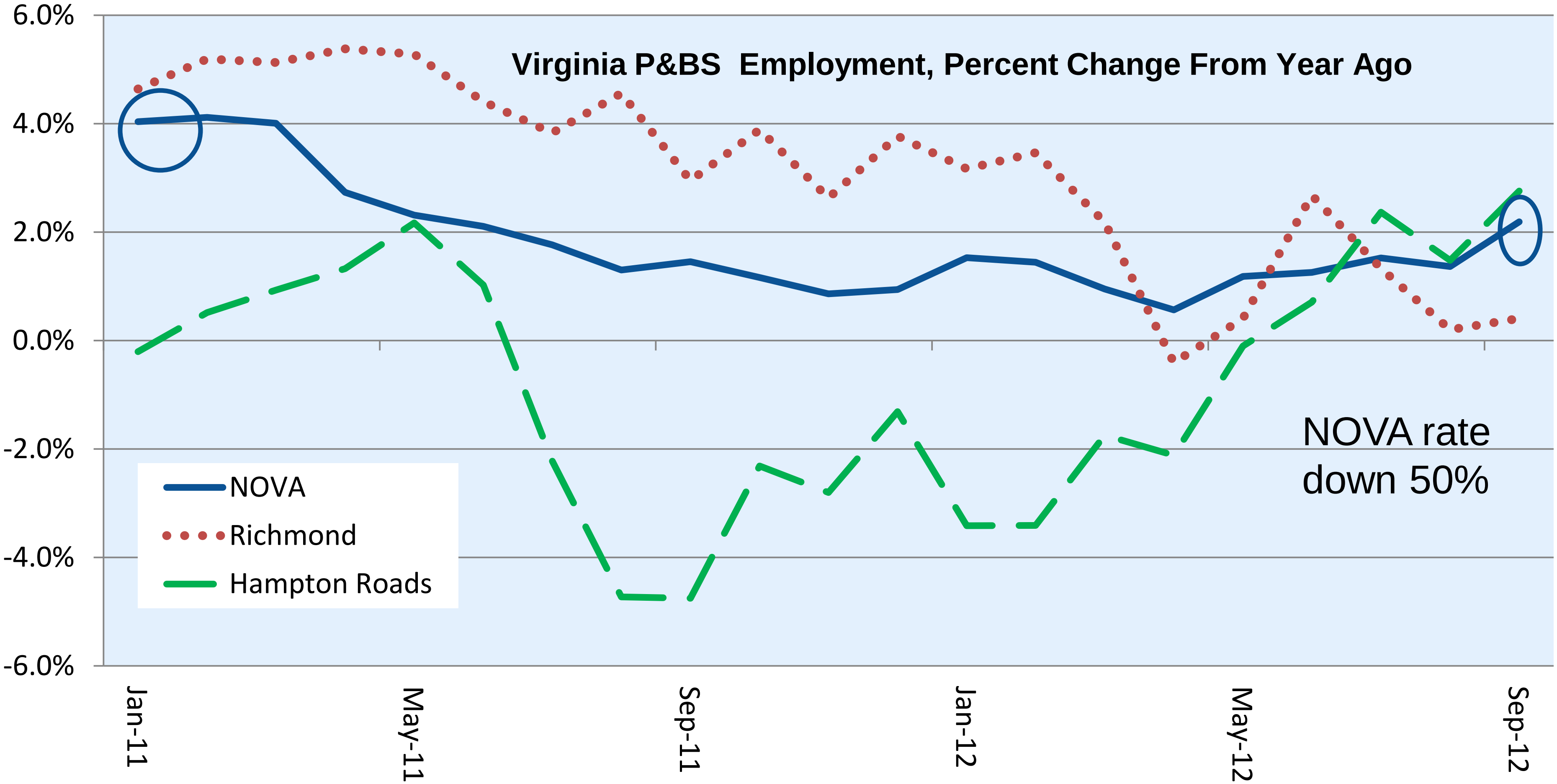
- Professional and Business Services accounts for 18% of Virginia's jobs and since the recession has driven most of Virginia's employment gains, grew at half the rate in FY 2012 compared to FY 2011
  - P&BS accounted for 49% of Virginia's job gains in FY 2011 but only 9% in FY 2012
- Federal spending represents nearly 40% of NoVa and Hampton Roads economies
  - Growth in P&BS jobs accounted for much of the job gains in these regions
  - Uncertainty about federal spending has had a "chilling" effect with employers

Virginia Monthly Employment, Percent Change From Year Ago



Source: Virginia Employment Commission.

The Rate of Employment Growth In Professional & Business Services Has Been Significantly Impacted In All 3 Major MSA's

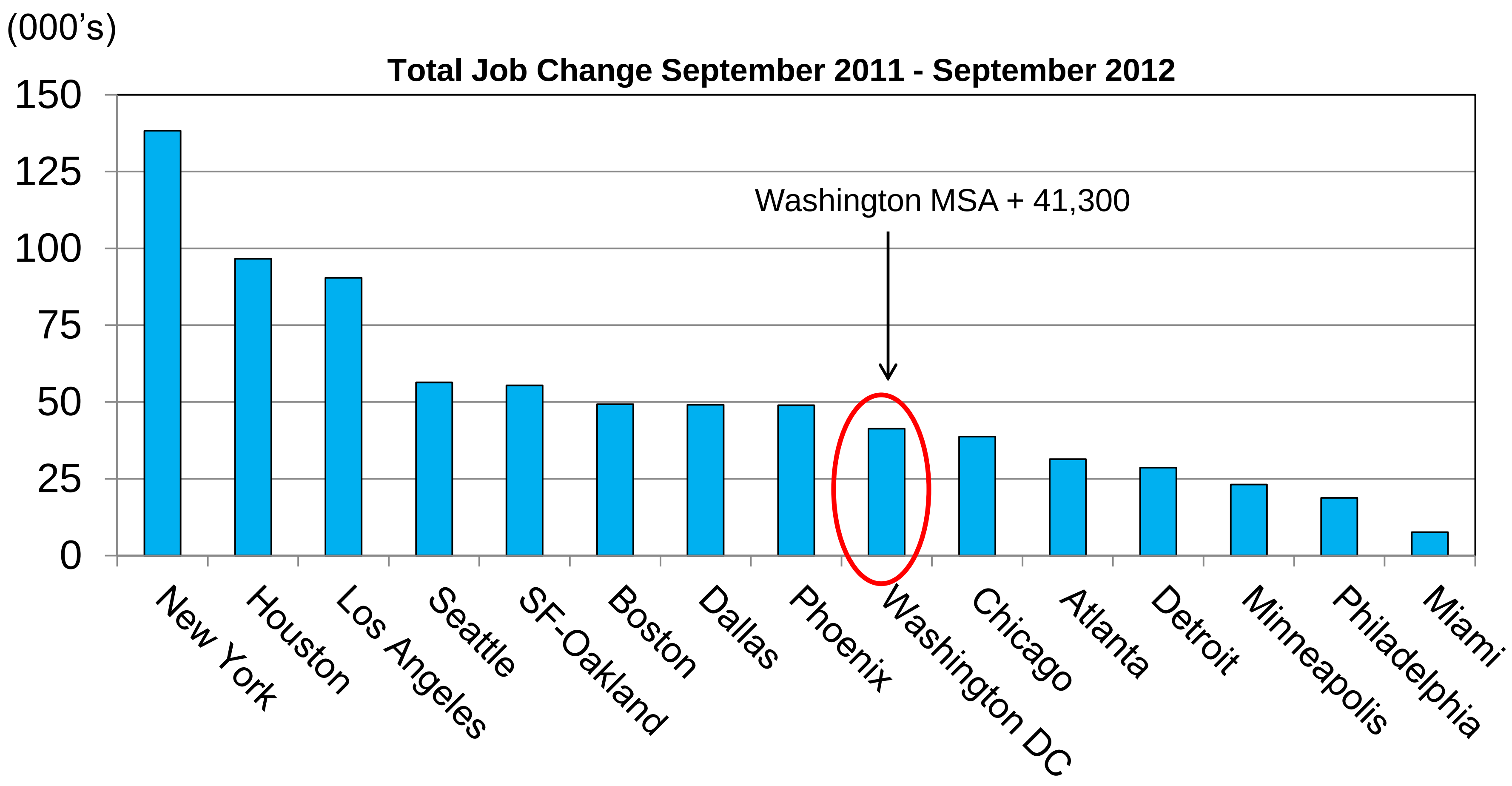


Source: Virginia Employment Commission.

Comparison of Virginia's Employment to Other States

- Virginia's unemployment rate of 5.9% is the 12th lowest and 3rd lowest among states with over 1 million in population
- However, Virginia is ranked 35th in terms of job growth for the September over September period compared to 18th a year ago
  - Virginia rate of growth was 0.86% compared to a national rate of 1.38% growth
- Washington/Northern Virginia had one of the smallest annual percentage job gains of any major MSA over 1 million population in August compared to the previous August
  - Currently ranked 15th out of 26 MSA's based on 12-month moving average
  - Was #1 last August

No Longer Number 1…NOVA/Washington Metro Area Ranked 15 Out of 26 in Job Gains

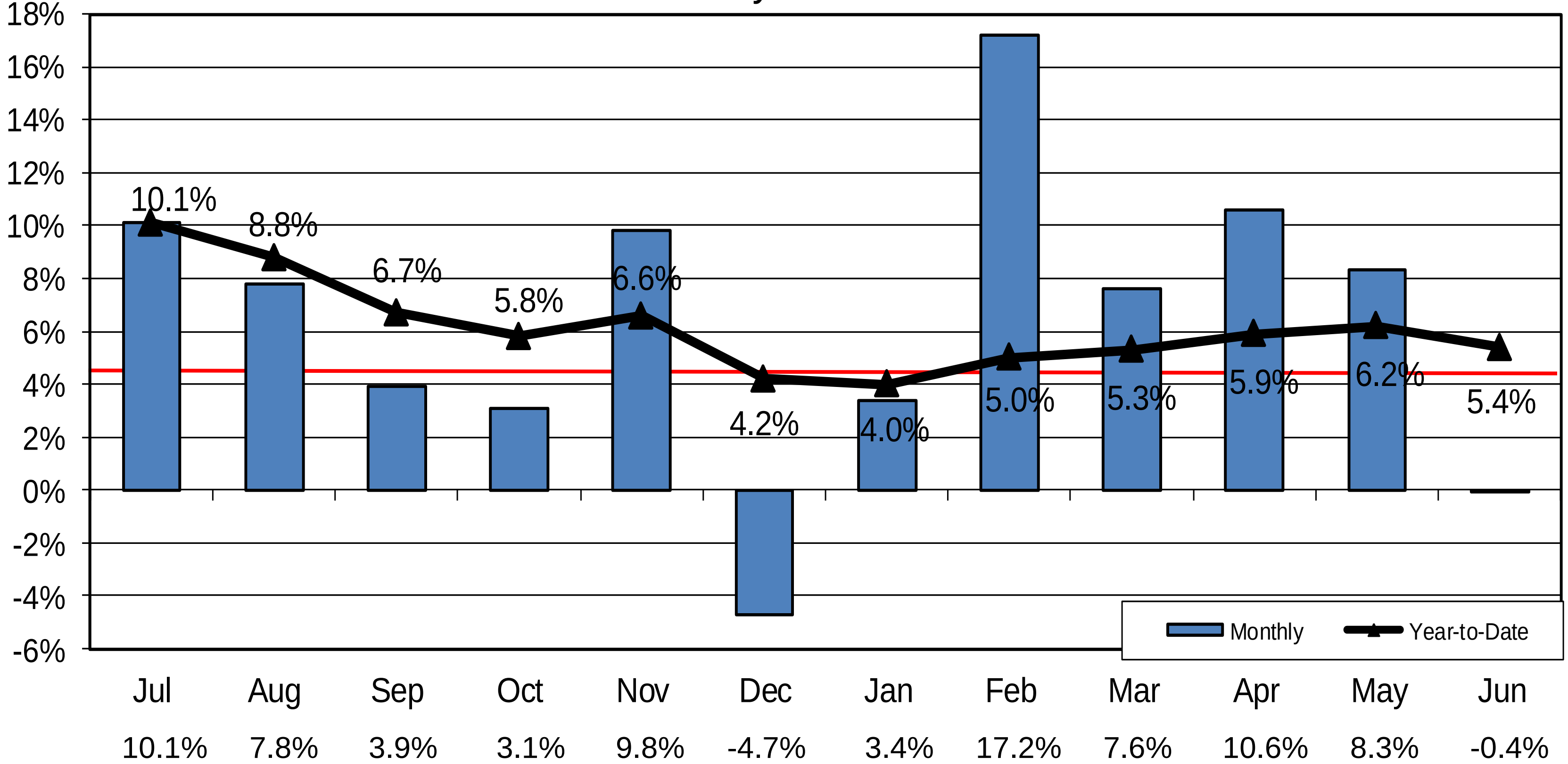


Source: BLS data, Seidman Research Institute, W.P. Carey School of Business, Arizona State University

FY 2012 Year-End Close

Growth in Total General Fund Revenue Collections

FY12 Monthly and Year-to-Date



- FY 2012 total general fund revenue collections rose 5.4%, ahead of the revised annual forecast of 4.5% growth - $123.1 million excess revenues
- Adjusting for the accelerated sales tax (AST) program, total revenues grew 5.4%, ahead of the economic-base forecast of 4.7% growth

Source: Secretary Brown's August 2012 presentation to Joint Money Committees

Where Did the FY 2012 Excess Revenues Come From?

Source	Difference from Forecast	
Refunds	+ $147.1 million	Refunds were down 4.5%, below forecast of 3.3% increase. Average refund down 7%
Sales Tax	+ $55.5 million	Adjusting for AST, sales tax grew about 3.9%, ahead of the economic-based forecast of 2.5%
Withholding	+ $33.7 million	Payroll withholding taxes make up 65% of GF revenue. Grew 4.2% compared to forecast of 3.8%
Corporate	+ $32.1 million	Collections grew 4.6%, ahead of the estimate of a 0.7% percent
Non-withholding	- $94.3 million	Makes up 14% of total revenues. Grew 8.2% percent in FY 2011 rather than projected 12.6%

Other Available FY 2012 Resources

- In addition to unanticipated revenues, agencies ended FY 2012 with $319.3 million of GF and NGF savings and balances
- In August the Governor reported that after commitments in Chapter 2 and other legal requirements, the unencumbered amount totals only $41.8 million
  - Allowing agencies to retain these amounts requires no budgetary action
- Last week the Governor reported his recommendations, the majority will be kept by agencies to address their needs
  - The remaining $7.5 million will be recommended for reversion and will be included as an addition to the balance forward in the Governor’s amendments in December

Governor's Announced Plans for Allocation of FY 2012 Surplus & Balances

$98.0 million	Mandatory reappropriation of nongeneral funds – largely higher education
$78.3 million	Revenue Stabilization Fund deposit from FY 2012 surplus (This amount is in addition to $166 million set aside in Ch. 3 for FY 14)
$77.2 million	3% Bonus – contingent appropriation included in Ch. 3 (2012-14)
$66.1 million	Transfer nongeneral funds historically reported as general funds
$30.0 million	FACT Fund Deposit – mandatory carryforward in Ch. 2 (2012)
$20.9 million	Pay Back Transportation for its Share of the Accelerated Sales Tax
$17.2 million	Natural disaster sum sufficient (in addition to existing amounts)
$16.9 million	Water Quality Improvement Fund
Available Excess	$41.8 million in discretionary reappropriations remain. Governor's budget amendments will either assume reappropriation of these amounts or propose using the balances for other one-time purposes

Virginia’s Revenue Outlook

FY 2012 Performance Slightly Stronger Than Anticipated but In-Line with Economic Forecast

- Because the FY 2012 collections exceeded the forecast by $123.1 million, FY 2013 will have to grow only 2.9% to meet the appropriated expenditures based on the forecast included in Chapter 3
  - This rate compares to the 3.7% forecast assumption prior to accounting for FY 2012 actuals
- The Fall forecast process is underway
  - JABE met in October
  - GACRE meets November 19
  - Governor will present amendments on December 17

FY 2013 Revenues: Will Early Year Performance Weaken as Year Unfolds?

- Outlook has not changed substantially since the forecast was presented in December, 2011
- The September 2012 Standard Outlook continued to indicate a growing, but very sluggish recovery
  - Growth in average wages has been revised slightly downward for both FY 2013 and 2014 and employment prospects are down for FY 2014
  - JABE members split on the Standard Outlook
  - Adjustments to economic indicators reflecting JABE sentiments could impact forecast presented at GACRE meeting next week
- Any reductions based on weaker economic variables will be offset in party by base adjustments resulting from FY 2012 performance

U.S. Economic Forecast

Percentage Change	FY 2013	FY 2014
National Forecast		
Real GDP		
Chap 3/Official	1.8	3.2
Sept 2012 Standard	1.9	2.2
Average Wage		
Chap 3/Official	2.3	2.8
Sept 2012 Standard	2.7	2.6
Consumer Spending		
Chap 3/Official	2.1	1.8
Sept 2012 Standard	2.1	2.5
Employment		
Chap 3/Official	1.0	1.8
Sept 2012 Standard	1.3	1.5

Virginia Economic Forecast

Percentage Change	FY 2013	FY 2014
Virginia Forecast		
Total Personal Income		
Chap 3/Official	3.5	4.0
Sept 2012 Standard	3.1	4.2
Average Wage		
Chap 3/Official	2.6	2.4
Sept 2012 Standard	2.3	2.3
Wages and Salaries		
Chap 3/Official	3.7	4.2
Sept 2012 Standard	3.5	3.8
Employment		
Chap 3/Official	1.0	1.8
Sept 2012 Standard	1.2	1.5

Summary of Fiscal Year 2013 Revenue Performance - July through October

General Fund Revenue Forecast for Fiscal Year 2013			
Major Source	**Source as a % of Total Revenues**	**Ch. 3 Official Forecast**	**Y-T-D Performance Through October**
Withholding	63.7%	3.5%	3.1%
Nonwithholding	15.0	3.6%	10.1%
Refunds	-11.8	7.8%	-6.9%
Net Individual	**66.9**	**2.8%**	**4.4%**
Sales	19.7	2.8%	7.6%
Corporate	5.4	3.0%	1.3%
Wills (Recordation)	2.0	0.3%	14.8%
Insurance	1.8	16.1%	--
All Other Revenue	4.2	2.3%	-8.5%
Total GF Revenues	**100.0%**	**2.9%**	**4.8%**

Source: Secretary Brown's October 2012 monthly revenue report.

Year-to-Date Performance: Individual Income Taxes

- Year-to-date, net individual income tax collections have grown 4.4% compared to a forecast of 2.8% growth
  - Strength comes from lower than forecast refunds, and higher than anticipated non-withholding tax revenues
  - Offsetting this is withholding tax collections which stand slightly below the forecast

Payroll Taxes:

- Forecast for year projects growth of 3.5%, actual collections through October grew 3.1%
  - October growth was 13.8% on a year-over-year basis, but the strength reflects a trueing-up of calendar days – 2 extra deposit days in October off-setting fewer deposit days in September
  - Appears to be close to on-target. Still down one deposit day overall which won't be picked up until June
  - Forecast already reflects weaker growth than last year when withholding collections grew 4.2%
  - Don't expect adjustment at this time

Year-to-Date Performance: Individual Income Taxes

Nonwithholding:

- Forecast for year is +3.6%, actual collections through October grew 10.1%
  - October growth was 43.2%, although it is not a significant month for nonwithholding
  - Over the last 10 years, Virginia has collected, on average, 17.9% of the year's withholding taxes in the first 4 months. Through October, total is 18.5% of forecast
    - This is a very volatile source and much depends on final payments. If the YTD trend were to continue throughout the year, would exceed forecast by $80 million. Because of uncertainty, assume increase of $65 million

Refunds:

- Forecast for the year is increase of 7.8%, actual refunds declined by 6.9% through October
  - Only time we have seen 2 consecutive years of shrinking refunds since 1990 was 2011 and 2012
  - So while projected growth rates seems high, can expect to see some increase this year. If one assumes 3% growth you would see a forecast reduction of $85 million

Year-to-Date Performance: Sales and Corporate Taxes

Sales Tax:

- Through October, sales tax collections grew 7.6% compared with the forecast of 2.8%
  - Exclusive of AST growth rate is 3.4% through October, ahead of the economic forecast of 1.7%
  - While year-to-date performance is promising, growth in October was only 1.1%
- The National Retail Federation's forecast for the upcoming holiday season is 4.1% growth which bodes well for additional growth
- If annual growth rate was adjusted to 4.0% in FY 2013, revenues would increase by about $40 million

Corporate Income:

- Corporate collections through October increased 1.3% compared with the forecast of 3.0% growth
  - October collections were strong, but it generally is not a significant month
  - Based on share collected during first 4 months over last 3 years, estimate appears high – if ratios hold true expect a slight contraction at a cost of about $60 million

Year-To-Date Performance: Other Major Sources

Recordation Taxes:

- Forecast for year is +0.3%, actual collections through October grew 14.8%
  - Last year we experienced 10.5% growth in this source
  - Even against a strong 4th quarter last year, the combined expectations of continued low interest rates, increased sales and uptick in higher average prices supports better than flat performance of this source
  - If you assume recordation taxes grow 10% again this year, provides an additional $31 million in revenues

Insurance Premium Taxes:

- Forecast for year is now 16.1% based on low FY 2012 performance which fell 12% below forecast
  - Chapter 3 assumed growth of 2.2% in FY 2013
  - If one assumes the Chapter 3 growth rate applies to the new base, the forecast would be reduced by about $33 million when one offsets the reduced amount due to transportation (which is based on prior year collections)

FY 2013 Revenues Might See Slight Upward Adjustment

- If the 3.7% growth rate included in Chapter 3 was applied to the 2012 actuals, the forecast would increase about $120 million
- Based on analysis of the individual major sources, and "money in the bank" through the first 4 months, anticipate growth in that range
- The net impact of the individual major source adjustments we've just reviewed would result in $124.8 million in revenues above the forecast, for a major source growth rate of 3.8%
  - The additional revenues would be achieved without assuming overall increased growth compared to Chapter 3
  - Still a very conservative forecast compared to historic trends

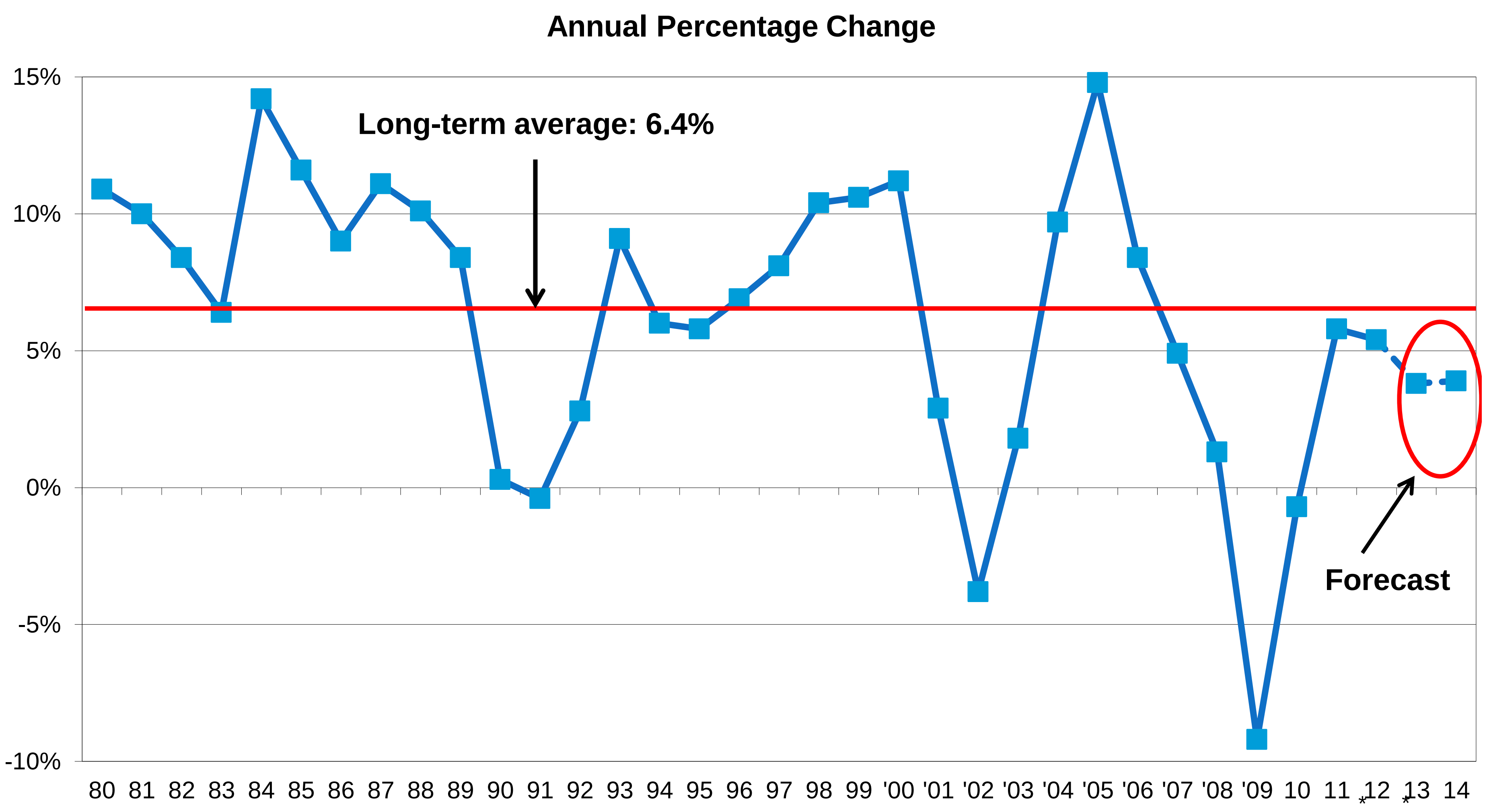
Current FY 2014 Budget Assumes 4.5% Core Revenue Growth

- Employment and wages and salaries are critical variables for the revenue forecast because they drive individual income and sales tax which together comprise 87% of the GF revenue
  - The September Standard forecast for job growth assumes 1.2% growth in FY 2013 and 1.5% in FY 2014
    - Remember - these growth rates don't reflect any downward adjustment that may occur based on JABE
    - First quarter job growth has been 1.0%
  - Average wage/salary assumption of 2.3% in each year reflects a reduction from last year
    - Driven by concentration of softness in higher-paying job classifications – especially Professional and Business Services
  - Overall, key indicators assume Virginia will continue to lag the nation in job growth and wage and salaries

Current FY 2014 Budget Assumes 4.5% Core Revenue Growth

- Based on the lower job and wage and salary growth, can assume a slight weakening in the economic-based forecast of 4.5%
- However, the ripple effect from FY 2012 and 2013 adjustments means if one reduces marginally the assumed growth for withholding and nonwithholding collections in FY 2014 it still results in a modest uptick in total revenues
- Expect positive upward adjustment in the $50.0 million range based on revised base offset by slightly weaker growth in the major sources
- This would mark the 8^{th} year revenues grew below 6%
  - Long-range average 6.4%

Actual General Fund Revenue Growth FY 1980-2012 Forecasted Revenue Growth FY 2013-2014



*Actual Collections FY 1980-2012, FY 2013-14 HAC Estimate. (All exclude transfers.)

FY 2012-2014 Revenue Forecast: What Changes Can We Expect to See

- **Current Revenue Forecast – Chapter 3**
  - FY 2013: 3.7% (2.9% required adjusting for FY 2012 performance)
  - FY 2014: 4.5%
- **Expect:**
  - HAC estimates would suggest that FY 2013 current performance might justify a slight uptick (to 3.8%), but given the cloud of uncertainty in FY 2014, a downward adjustment to 4.0% could be prudent
  - Results in a total upward biennial revenue adjustment in the range of $175 million
- **Means that:**
  - Most of the revenue adjustments will accrue in FY 2013 and be carried-forward into FY 2014
  - Any budget amendments should be limited to mandatory items so as not to exacerbate any structural imbalance

Balancing Virginia's 2012-2014 Biennial Budget on Below Trend Revenue Growth

2012-14 Budget Drivers:
Selected Mandatory/Statutory Items

GF $ in Millions	FY 2013	FY 2014	Total
Medicaid Utilization & Inflation (excl. hospital rebasing)	(83.8)	(78.6)	(162.4)
Medicaid Hospital Rebasing		82.0	82.0
Medicaid Forecast Correct. for Teaching Hospitals		11.3	11.3
FAMIS/CHIP Forecast Adjustment		17.6	17.6
DBHDS - DOJ Adult & Children's Crisis Services	-	5.3	5.3
DSS - IT Costs for Caseload Growth in Mandated Programs (TANF, SNAP, Medicaid, LIHEAP)	1.9	2.2	4.1
DBHDS - Part C Early Intervention Services	2.0	2.0	4.0
Medicaid MMIS Upgrades & VITA Costs of eHHR	0.8	1.0	1.8
DBVI - State Match for Vocational Rehab Services	0.5	1.0	1.5
DBHDS - IT Costs of eHealth Records	0.6	0.6	1.2
DSS Eligibility & Services Systems Modernization	0.3	0.5	0.8
K-12 Prelim Technical ADM Updates (SOQ, Incentive & Categorical) Estimates	2.1	6.0	8.1
Lottery Balances from FY 12	(23.0)	-	(23.0)
Sales Tax Forecast Update	??		??
State Employee Health Insurance Rate Adjustment	-	70.0	70.0
Lawrenceville Rate Adjustment	1.3	1.3	2.6
Jail Per Diems	6.3	-	6.3
1:1500 Ratio	-	4.6	4.6
Direct Inmate Health Care	-	22.8	22.8
Tax Dept. - IRS Mandated System Modifications	-	2.8	2.8
Criminal Fund	2.0	3.1	5.1
TOTAL – Mandatory/Statutory Budget Drivers	**$ (89.0)**	**$ 155.5**	**$ 66.5**

2012-14 Budget Drivers:

Selected High Priority Items

GF $ in Millions	FY 2013	FY 2014	Total
DBHDS - MH Hospital Discharge Assistance Funds	-	1.5	1.5
DARS - Public Guardian & Conservator Program	-	1.3	1.3
DMAS - Dual Eligible Demonstration Program	-	1.0	1.0
DBHDS - Continue Funds for Beds at NVMHI	-	0.7	0.7
K12 - Early Reading, Industry Certifications Fees & Academic Reviews, Student Data System	-	1.4	1.4
O & M New Facilities	-	7.0	7.0
New I/S Seats at CWM, JMU, UVA, & VT	0.3	3.3	3.6
BRAC - Oceana		7.5	7.5
FACT Fund	??	??	??
DOC Backup Generators and Phone System	-	4.0	4.0
Funding for New Jails	-	2.9	2.9
VDEM VITA Transformation	0.6	1.6	2.2
State Police Driver Training Facility Support	-	1.7	1.7
DOC Electronic Health Records	-	2.5	2.5
Employee Health Insurance - Restore IBNR reserve	-	36.0	36.0
SCV - Eliminate/Reduce Savings from Judicial Vac.	-	4.7	4.7
Comp Board - 2nd Year Funding for Career Dev.	-	1.1	1.1
TOTAL – Known High Priority Budget Drivers	**$ 0.9**	**$ 78.2**	**$ 79.1**

2013 Session – Continued Restraint Required

- Based on an analysis of projected revenues and economic variables, HAC staff estimates upward revenue adjustments of about $175 million over the FY 2012-2014 biennium
  - Most of the upward adjustments apply to FY 2013
  - Need to carry-forward a substantial FY 2013 revenue balance to cover FY 2014 costs
- Known biennial mandatory and high priority budget pressures total about $145 million
  - Includes reductions in mandatory spending of $88.1 million in FY 2013
  - Increases in projected mandatory spending of $233.7 million in FY 2014
- The known mandatory and high-priority budget drivers do not include addressing our pre-existing reliance on accelerated sales tax and the local-aid reversion account, both of which the General Assembly has worked to eliminate

2013 Session – Planning for Uncertainty

- Last week the Governor asked all agencies to submit 4% budget reduction plans for his consideration
  - This marks the 5th consecutive year that agencies have been asked to produce such plans
  - If there are no exclusions, this would amount to $680 million of options for consideration
  - If exemptions are made similar to last year, total would be about $150 million
    - Medicaid, K-12, higher education addressed via targeted strategies
  - Many of the strategies are likely to mirror those offered but not adopted in prior years
- Agency savings may not be required to meet current budgetary obligations, but could provide a roadmap of options if reductions become necessary

Final Thoughts on 2013 Session Outlook

- The revenue outlook for FY 2013 and 2014 would mark 4 years of below trend growth <u>AFTER</u> two consecutive years of decline
- Virginia's growth has been lagging the nation's and we may face more instability than the nation as whole going forward
- Last year's forecast embedded slower employment growth based on the national level uncertainty so while not representing a "worst case" case scenario the forecast is conservatively drawn
- Impact of cuts to federal spending – especially defense spending – are the greatest unknown facing Virginia

Budget Control Act and the Fiscal Cliff

Background: Role of Federal Spending in Virginia

- While the “fiscal cliff” is clearly a national issue, Virginia could be disproportionately impacted by it
- Virginia is the number one recipient of federal procurement spending on a per capita basis
  - 32% of Virginia’s total Gross State Product (GSP) comes from direct federal expenditures; 13.8% comes from procurement spending alone
- Federal spending is concentrated in Virginia’s two largest regions
  - Direct federal spending makes up 36% of the total economy in the Washington D.C. area – exclusive of the substantial indirect effects
  - ODU estimates that 45% of the gross state product (GSP) in Hampton Roads is attributable to direct and indirect Defense Department spending

Source: Census Bureau’s “Federal Aid to States” FFY 2010

Overview

- Timing of Fiscal Cliff
- Provisions of the Budget Control Act of 2011 (BCA)
- Impacts of Federal Budget Reductions and BCA on Virginia
  - Budgetary Impacts
  - Revenue Impacts

Key Dates in the Federal Fiscal Cliff

September 2012	Congress passed Continuing Resolution keeping government operating until March 27
November/Dec 2012	“Lame Duck” Session
December 2012	Tax rate cuts, and expansion of credits and deductions enacted in 2001, 2003 and 2009 expire
December 2012	Social Security tax (2%) cut ends, unemployment insurance extension ends, Medicare payment rate reduction set to go into effect
December 2012	Reauthorizations – TANF, No Child Left Behind, Workforce Improvement Act, Farm bill
January 2, 2013	Sequestration goes into effect
February 2013	Debt ceiling reached
March 27, 2013	End of Continuing Resolution

Budget Control Act (BCA) of 2011: Overview

- The BCA was adopted in August 2011 as part of agreement to allow for a $2.1 trillion increase of the federal debt ceiling in exchange for a like reduction in federal spending through FFY 2021
- Pot 1: Includes 10-year discretionary spending reductions of $917 billion over the baseline estimate effectuated through overall spending caps
  - No Congressional discussion about amending this portion of the Act
  - No exemptions from this section and cuts are <u>not</u> across-the-board so Appropriators will determine which programs are reduced on an annual basis
  - Inflation adjustments and demographic adjustments out
  - Some programs will be substantially diminished/eliminated

Budget Control Act of 2011

- Pot 2 reductions total $1.2 trillion through 2021, split 50/50 between defense and non-defense activities
  - Total required cuts reduced to $984 billion over the 9 years between FY 2013 and FY 2021 after assumed interest savings are applied
    - $492 billion each in non-defense discretionary/mandatory spending and defense discretionary spending
    - Annual cut of $55 billion for each category
- The Act directed the “Super Committee” to determine where to take the Pot 2 reductions by a December 2011 deadline
- Failure to reach any agreement set in motion sequestration, which is the cancelation of a portion of budgetary resources
  - Goes into effect on January 2, 2013, unless Congress intervenes
  - Intended to be so severe that Congress would have to act

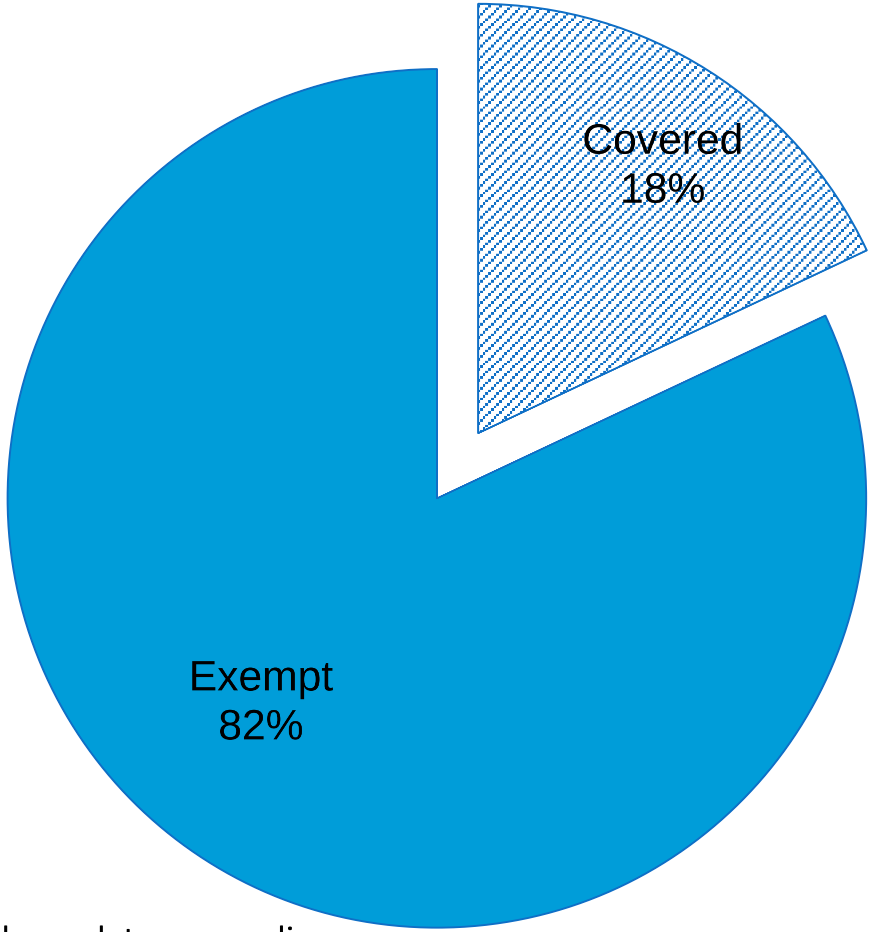
Sequester: What We Do and Don't Know

- What size are the cuts?
  - 9.4% reduction in defense discretionary spending
  - 8.2% reduction in non-defense discretionary spending
    - Lower because small portion of cuts apply to mandatory non-defense spending
  - Exact percentage won't be known until January 2013 (at the earliest)
- How much discretion do agencies have in implementing sequester?
  - Virtually none – cannot select among programs – each cost code receives proportional cut
  - Some influence over timing – e.g. education cuts can be applied to 2013-2014 school year
- What is required to stop sequestration?
  - Explicit legislation required
  - Various proposals, no agreement

Most Non-Defense Programs Are Exempt… Which Means the Few Left Take Large Cuts

Exemptions Include:

- Medicaid (vendor payments and administration)
- Children's Health Insurance Program
- Most child nutrition and SNAP programs
- Most child care, child support enforcement, foster care and adoption assistance programs
- Pell Grants
- Most Transportation Programs



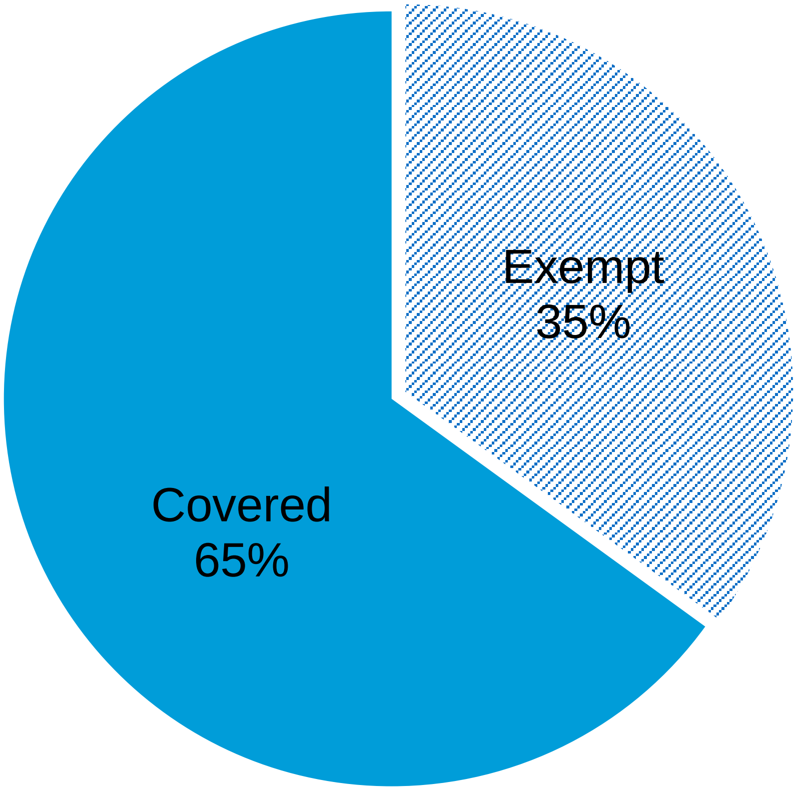
Based on FFY 12 domestic discretionary and mandatory spending.
Source: NCSL

On The Defense Side, One-Third of the Spending Is Exempt

Major Exemption

Is military personnel

salaries



Based on FFY 2012 spending.

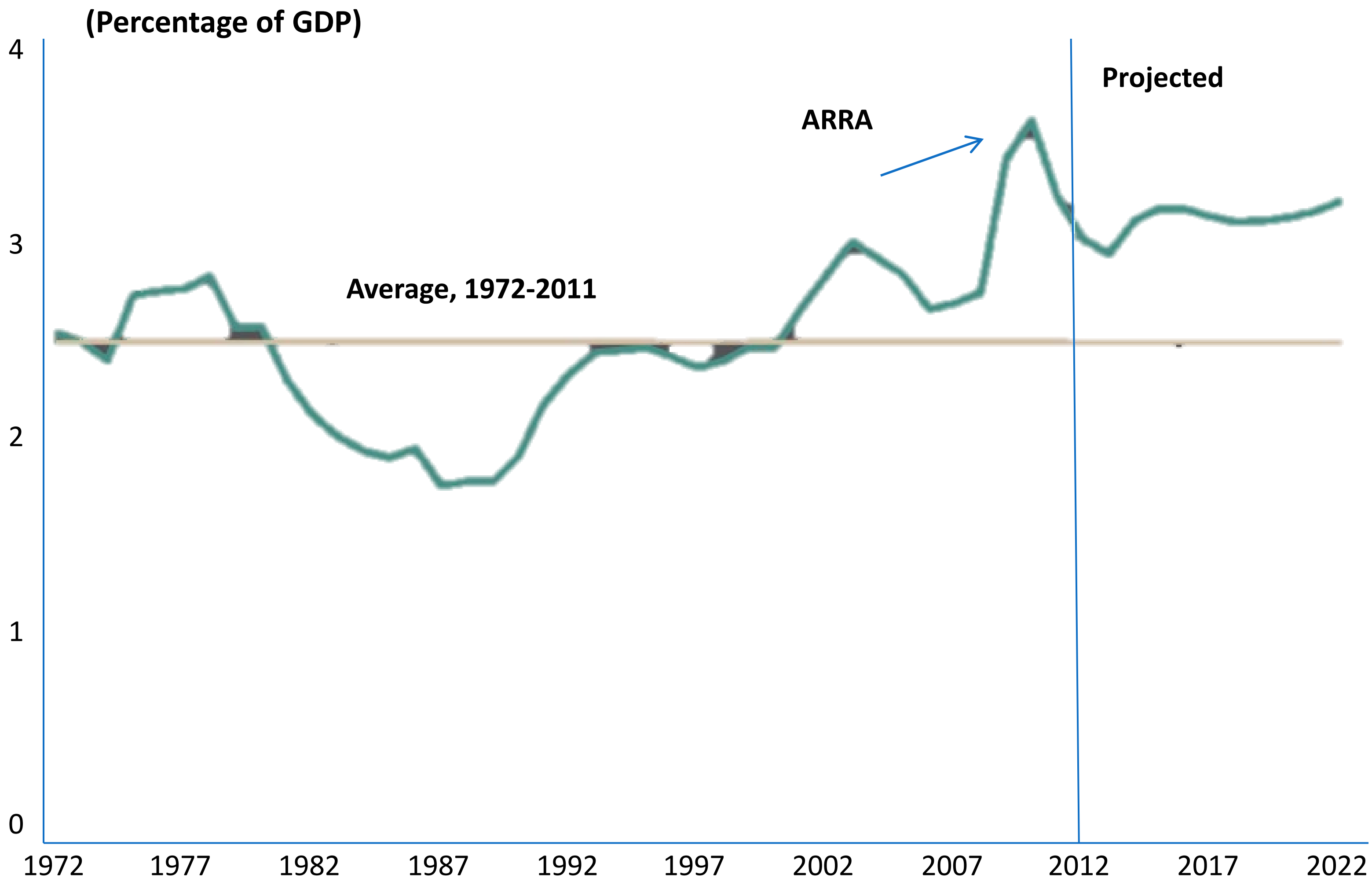
Source: NCSL

Long Term Budgetary Impacts of BCA

- How will the cuts outlined in the Budget Control Act effect long-range federal spending levels?
  - Congressional Budget Office projects that non-defense discretionary spending will be 10% lower in 2021 than if discretionary spending grew from 2012 amounts at the rate of inflation
    - According to their analysis, discretionary spending as a share of GDP will fall to its the lowest level in at least 50 years
  - Yet federal expenditures for Medicaid and CHIP are projected to increase by 47% by 2021 even under the reduction plan
  - As a net result, the share of GDP related to total federal grants in aid to state and local governments will be no lower in FY 2021 than today and will be about one-third higher than the average between 1972 and 2011
    - Mirrors problems we already have seen at the state level

Congressional Budget Office, “An Update to the Budget and Economic Outlook: Fiscal Years 2012-2022”, August 2012.

Federal Grants-in-Aid to State and Local Governments



Note: Preliminary estimates using the framework of the National Income and Product Accounts, including grants-in-aid and excluding most transportation spending. ARRA = American Recovery and Reinvestment Act (the source of the increase in 2009 and 2010).

Source: Congressional Budget Office

What Does This Mean for Virginia? – Budgetary Impacts

Size of Federal Grant Programs in Virginia

- Virginia received less federal aid to state and local governments on a per capita basis than any other state in the nation in FY 2010
  - Nonetheless, federal grants amounted to $10.6 billion in FY 2010 according to the last Consolidated Federal Funds Report
- Federal grants to Virginia decreased by $700 million between FY 2010 and FY 2012 even prior to the BCA
  - Totaled $9.9 billion in FY 2012, making up about 24% of Virginia's operating budget
    - On average, U.S. states depended on federal grants for 32% of their revenue in 2010
  - The largest program areas supported by federal funding are health and human resources and transportation, much of which is exempt from sequestration

Source: U.S. Bureau of Census, Consolidated Federal Funds Report

Sequestration's Impact on Federal Grants to Virginia

- Because the cuts are against the baseline assumptions of total federal budgetary growth, and so many programs are exempt, the impacts are felt disproportionately
- This means exempt programs – many of which are both large and have high growth rates - will continue to increase, e.g. Medicaid
- As a result, most states would see overall <u>net</u> increases in federal grant funding in FY 2013 even after a sequester
  - Virginia is projected to see an overall 3.0% increase in federal grants in FFY 2013 with sequestration
- But because total reductions have to be achieved through reductions to a small percentage of the budget, the remaining programs face substantial cuts
- What about those programs impacted?
  - Many are non-mandatory in nature, but policy considerations may result in state deciding to backfill the lost funding

Share of Grants in Aid Supporting State/Local Governments Subject to Sequester

Budget Function	% of Grant Funding Subject to Sequester
Agriculture	100%
Employment and Training	100%
Community and Regional Development	90%
Energy, Environment and Natural Resources	78%
Justice	62%
Education (only major exclusion is Pell Grants)	54%
Income Security and Social Services	23%
Health	4%
Transportation (GF transfers to TTF and transit new starts NOT exempted)	4%

Source: Federal Funds Information for States

Estimated FY 2013 Total Federal Grants to Virginia Under Sequestration

($ In Thousands)			
	FY 2012	FY 2013CR w/ Seq.	vs. FY 2012
Total Federal Grants to Virginia - Includes Exempt from BCA			
Virginia – All grants	9,907,169	10,219,901	312,732
Funding to VA for Major Programs Subject to Sequester			
WIC	98,558	91,030	(7,528)
Title I Educ	229,980	212,413	(17,567)
Special Ed	281,476	259,976	(21,500)
Head Start	115,652	106,818	(8,834)
Voc Rehab	66,791	63,875	(2,916)
Childcare Block Grant	43,445	40,127	(3,318)
LIHEAP	80,436	74,292	(6,144)
SS Block Grant	43,809	40,589	(3,220)
Subst. Abuse	42,762	39,496	(3,266)
CDBG	48,667	44,950	(3,717)
EPA Water	44,431	41,037	(3,394)
VEC Programs	108,314	100,041	(8,273)

Source: Federal Funds Information for States, Vol 12, No. 3, September 2012

What Does This Mean for Virginia? – Revenue Impacts

Revenue Impact of Reduced Federal Spending Far Exceeds Budgetary Impacts

- While the impacts of federal cuts on Virginia's budget may not be insurmountable, as the largest per capita recipient of procurement spending Virginia faces a greater potential of negative effects in the form of reduced tax revenues resulting from cuts in procurement contracts
- Procurement spending in Virginia totaled $59.5 billion, with $42.8 billion in defense procurement alone
  - Virginia is particularly vulnerable to defense cuts which are estimated to account for 71% of all federal cuts in the state in FFY 13
- Federal payroll spending in Virginia - which was $23.1 billion in FY 2011 – also is more significant to our economy the grants in aid
- For comparison, a 5% cut in procurement, salaries and other non-grant spending would reduce federal spending in Virginia by $850 per capita
  - An equal percentage cut to government grants would amount to $67 per capita
- As a result, it the potential revenue reductions from sequestration far exceed the direct state spending impacts

Projected BCA Impacts on Virginia's Economy

- The Virginia Economic Development Partnership commissioned Chmura Economics and Analytics and GMU's Center for Regional Analysis to conduct an economic analysis of the potential impacts of federal cuts
- The report was released on October 10, 2012 and breaks down the impacts of federal budget reductions by region, industry and job classification
- They report that a "worst case" scenario where the BCA could result in discretionary payroll and procurement spending reductions of $11.7 billion in Virginia during federal fiscal years 12 and 13
  - This exceeds the total federal funding provided to support state programs last year
- Multiplier effects created by the reduced purchases from suppliers and decreased household spending would result in a 2-year reduction in spending of $22.7 billion in Virginia

Projected BCA Impacts on Virginia's Economy

- In terms of employment, the report identifies a "worst case" Virginia scenario resulting in the loss of 82,099 Virginia jobs over the two-year period
- When indirect and induced jobs are added to the equation, the total employment impact estimated at a reduction of 164,225 jobs
  - Northern Virginia is projected to absorb 60% of the losses
  - Hampton Roads approximately 20%
  - Richmond 12%
- In combination, this would reduce their baseline assumption of 1.15% annual employment growth in Virginia and instead assume job losses of 1.15%
- Which sectors are most impacted?
  - The professional and business services sector would suffer the greatest losses at just under 40,000
  - Another 23,712 jobs would be direct federal workforce positions

Estimated State Tax Impact of Federal Reductions in Virginia

($ in millions)

	Direct Jobs	Indirect Jobs	Induced Jobs	Total Jobs
Reduced Employment	41,049	12,504	28,559	82,113
	Lost Revenue - Direct	**Lost Revenue – Indirect**	**Lost Revenue – Induced**	**Total Lost Revenue**
Reduced Sales Tax	$0.0	$2.1	$22.7	$24.8
Reduced Individual Income Taxes	155.8	19.7	46.0	221.6
Reduced Corporate Income Taxes	17.7	16.5	49.8	84.0
Total	**$173.5**	**$38.4**	**$118.5**	**$330.3**

Source: Chmura Economics and Analytics report "Assessing the Impact of Federal Budget Cuts on the Virginia Economy," VEDP, October, 2012. Figures represent annual average.

Budgeting for the Unknown

- While the impact federal support for Virginia's budgetary programs alone is substantial, the revenue impacts of direct and multiplier effects of procurement spending reductions could severely impact Virginia's tax collections
- We will have to live with a large degree of uncertainty – no magic formula to apply
- But, Virginia's revenues will likely reflect slower rates of assumed job growth – especially in regions most dependent on federal spending
- We have already seen the "indirect" impacts of federal belt tightening as concern about the potential for cuts has impacted companies decisions to hire workers

Tools to Respond to Potential Budgetary and Revenue Impacts

Repeat 2009 ARRA Model	• Virginia first state to adopt budget/end Session • Best case-scenario on timing of agreement in Washington barely prior to adjournment • Provide broad authority in Act for issue to be addressed
Federal Action Contingency Fund	• 2012 Caboose Bill appropriated $30.0 million GF as an initial capitalization of the Fund • These amounts were not utilized in FY 2012 but carry-forward into the current biennium
FY 2014 Payroll Reserve	• Enacted budget includes a contingent appropriation of $54.7 million for an August 2013 employee 2% pay raise • Raise is dependent on revenue forecast not being revised downward
Rainy Day Fund	• Can be tapped only if appropriations exceed revenue forecast by 2% • Mandatory deposits of $132.7 million in FY 2013 and $244.6 million in FY 2014 regardless of changes in economy • Balance available will be $689 million by 2014
Agency Reduction Plans/Special	• Authority exists to call Special Session to address issue • Governor can implement cuts under authority in Part 4 • Reconvened Session