Virginia's Revenue Outlook

Senate Finance Committee
November 15-16, 2007

Virginia's Revenue Outlook: The overall backdrop. . .

*Concluding remarks, **2006 Senate Retreat**: "The economic forecast may not have captured all of the ripple effect of the housing slowdown **. . . . caution is our friend."***

- Caution has now become our <u>best</u> friend, as economic uncertainty has risen sharply since last year:
  - Job growth has slowed; but, is it really even slower than reported?
  - Will income growth look as good at the end of the year when bonuses are handed out?
  - Can consumers continue to spend well beyond their means with credit card debt, now that home equity is no longer a cash machine?
  - Will businesses expand when the jury is still out on consumer spending?
  - Are large, multi-national companies with strong global sales masking underlying weakness in the stock market?
  - Will tighter credit conditions throw cold water on an already cool economy?

Virginia's Revenue Outlook: The overall backdrop. . .

- Confidence is a key factor -- both consumer and small business confidence have dropped substantially.

  - Deep housing downturn; no end in sight;
  - Erosion of wealth effect;
  - Tighter credit in response to "lax lending gone bad";
  - Fewer jobs being created;
  - No seasonal drop in gas price; oil approaching $100/barrel;
  - Higher grain prices signal higher food cost.

- Fed Beige Book (October): "To keep the economy expanding, it is vital that companies and people spend and invest at a significant pace. The big worry has been that they will cut back sharply."

  - A key question is how tighter credit will affect spending and investment.

  - Most economists believe we will have several quarters of very low growth, but that a recession can be avoided; however, **it's important to remember that recessions occur when low growth rates collide with external shocks or after-shocks**.

Virginia's Revenue Outlook: First, a look back. . .

FY 2007 Results:

- Revenues were $234 million short of forecast.

Revenue Source	% of GF	Variance $ in millions
Gross Individual Inc.	72%	**+111.0**
Refunds	(9%)	**(222.7)**
Sales	20%	**(43.8)**
Corporate	6%	**(11.5)**
Interest earnings	1%	**(57.5)**
All other	10%	**(9.9)**
Total All	**100%**	**(234.4)**

- Half of the "weakness" came from non-economic factors:

  - **Refunds**: $75 million in land preservation tax credits were claimed earlier than expected; TAX staff reduced cost estimate for low-income tax credit by $33 million (original estimate was correct).

  - **Interest**: Total interest earnings met the estimate; however, the assumed allocation of earnings between the GF/NGF was incorrect.

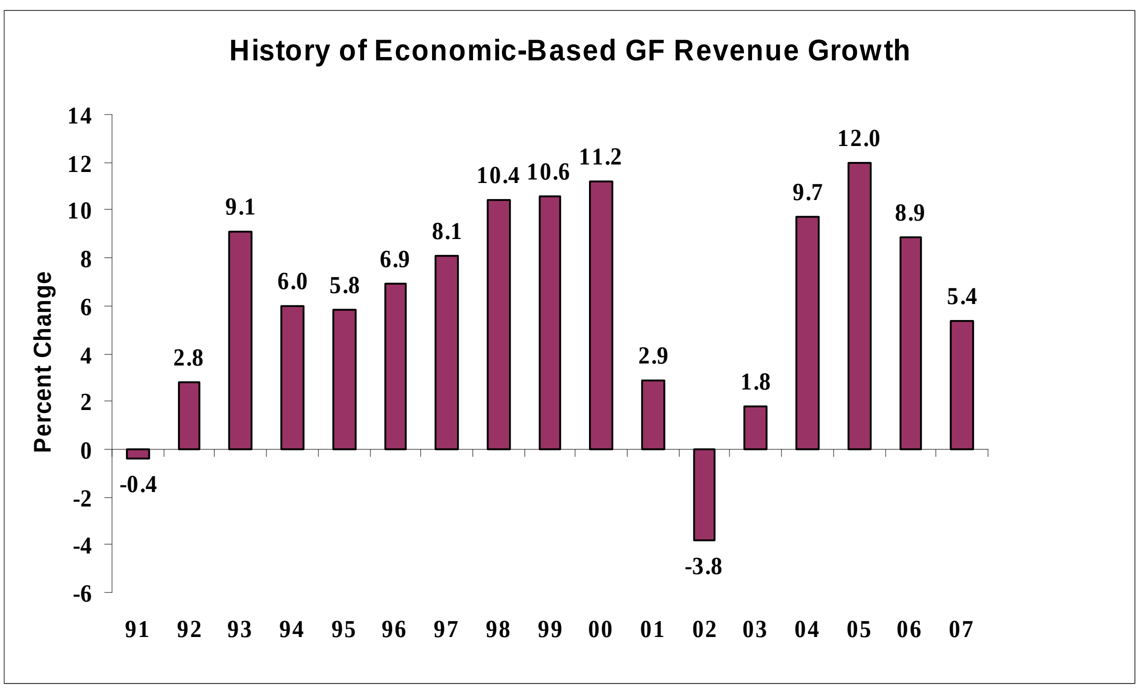
Virginia's Revenue Outlook: First, a look back. . .

- The other half reflected economic "weakness":

  - **Refunds**: Roughly $100 million of income tax collections above the estimate were returned to taxpayers through higher-than-expected refunds.

  - **Sales tax and corporate**: Economy was slightly softer than expected (corporate refunds kicked up about 25 percent).

- The FY 2007 revenue forecast assumed a substantial slowdown in growth; actual economic performance was about three-quarters of a percent lower than expected.



Virginia's Revenue Outlook: FY 2008 - The current fiscal year. . .

- Growth is expected to continue slowing in FY 2008, based on a reduced estimate of job growth.

	Job Growth	Wage/Salary Growth	Income Growth
FY 2007	1.4%	5.4%	5.2%
FY 2008			
Official forecast	1.8%	6.1%	6.2%
Interim forecast	1.3%	5.5%	5.6%

  - To date, overall construction jobs have not declined substantially because non-residential construction has picked up the slack; however, private non-residential is close to market saturation.

  - Financial institutions are starting to lay off workers.

  - Service jobs are expected to grow below trend.

- Tax policy adjustments will trim the growth rate by six-tenths of a percent, or $104 million.

- The Interim forecast presented by the Governor in August assumes a 3.0 percent growth rate for FY 2008.

Virginia's Revenue Outlook: FY 2008 - The current fiscal year. . .

First Quarter, FY 2008 Results:

Source	% of GF	YTD Growth	Interim Est.
Withholding	56.7%	**4.7%**	6.0%
Nonwithholding	18.9%	**10.7%**	6.6%
Refunds	(10.8)%	**(24.1%)**	10.5%
Net Individual	64.9%	**7.1%**	5.4%
Sales	19.6%	**3.1%**	2.8%
Corporate	4.5%	**(13.5%)**	(18.4%)
Recordation	3.3%	**(13.3%)**	(9.0%)
Insurance	2.5%	**15.8%**	2.9%
All Other	5.3%	**(2.7%)**	5.2%
Total	100.0%	**3.6%**	3.0%

- First quarter results suggest that FY 2008 may slightly outperform the Interim forecast.
  - Withholding is slightly understated due to number of deposit days included; (*Growth through October increased YTD to 6.4%).*
  - Non-withholding should be buoyed by stock market performance and the estimate by mutual funds that they will make the largest distribution of taxable gains ever this year.

Virginia's Revenue Outlook: Looking Ahead to FY 2008-10. . .

- Economic data underpinning Virginia's revenue forecast for the 2008-10 biennium has changed little since May when the Interim forecast was developed.

	Job Growth	Wage/Salary Growth	Income Growth
FY 2009			
Interim forecast	1.6%	5.7%	6.0%
September Std	1.5%	5.2%	5.9%
FY 2010			
Interim forecast	1.8%	6.2%	6.2%
September Std	1.8%	6.0%	6.2%

- The primary difference is in FY 2009, where projected job growth has been lowered slightly and projected wage/salary growth has been lowered by half a percentage point.

- That downward adjustment is intuitive since housing is not expected to correct for at least 12 to 18 months.

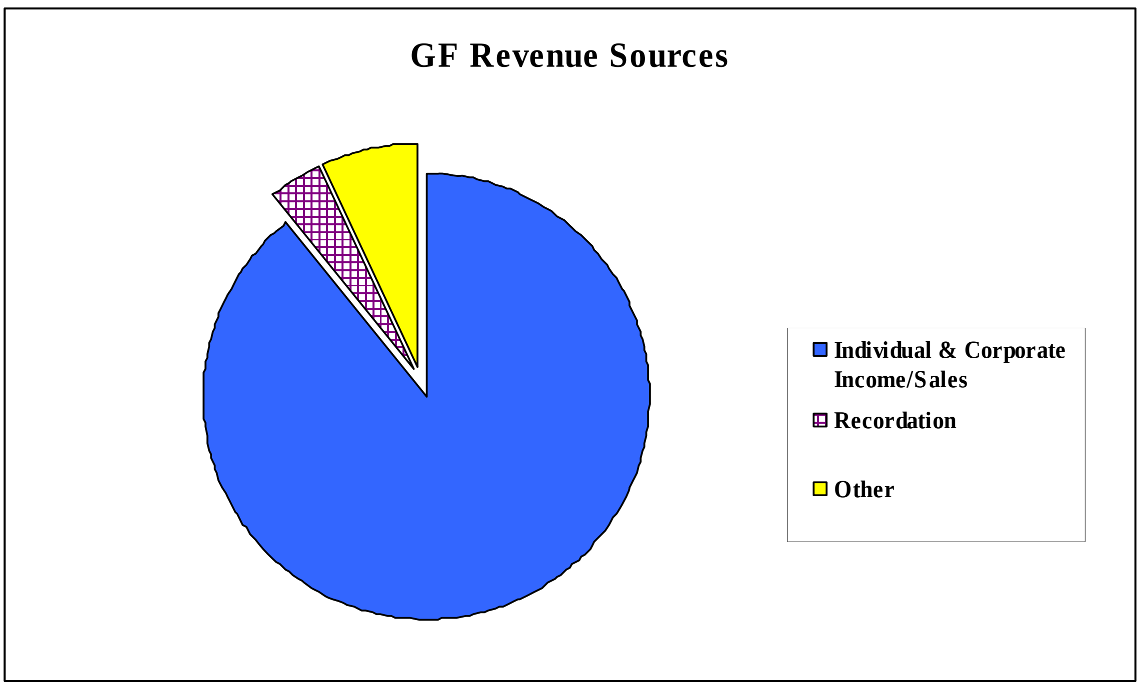
- The **danger is that it is too optimistic** a picture, as will be discussed later.

Virginia's Revenue Outlook: Looking Ahead to FY 2008-10. . .

- Projected income measures (wage/salary and income growth) are the most important components of the revenue forecast.

- Major revenue sources link back to how many people are employed, what they are paid, and how much disposable income they have.

  - Corporate income tax is indirectly related to income measures because business activity and consumer spending are inextricably linked.



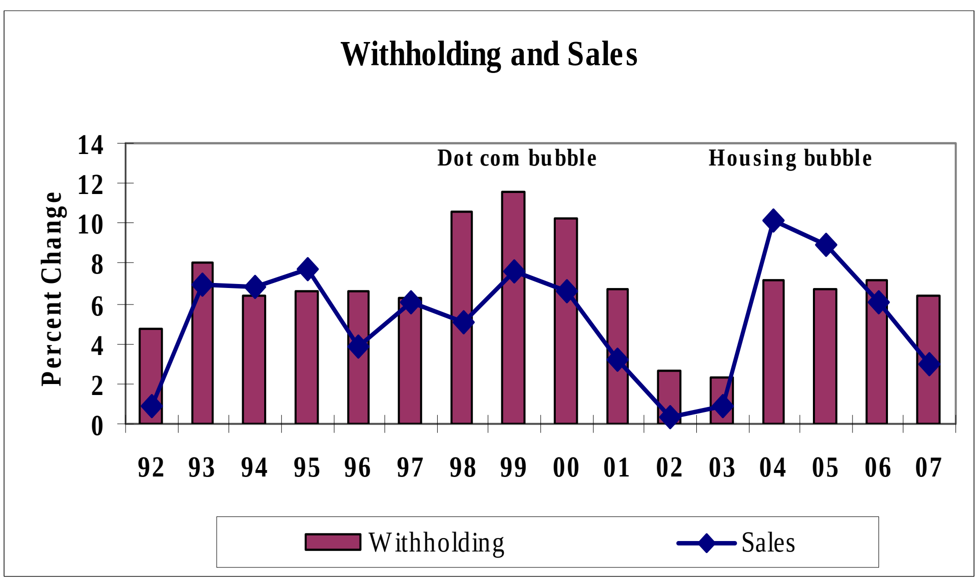
Virginia's Revenue Outlook: Looking Ahead to FY 2008-10. . .

<u>**What are the relationships that drive the forecast?**</u>

- In an expanding economy, ***withholding*** growth will exceed wage/salary growth because all the new jobs are not being counted.

  - Likewise, ***sales*** tax growth will exceed income growth for the same reason; in addition, sales tax has been inflated in recent years by equity withdrawal from rapidly rising home values.

- **In a slowing economy, withholding and sales tax growth should be in line with wage/salary and income growth**.



Virginia's Revenue Outlook: Looking Ahead to FY 2008-10. . .

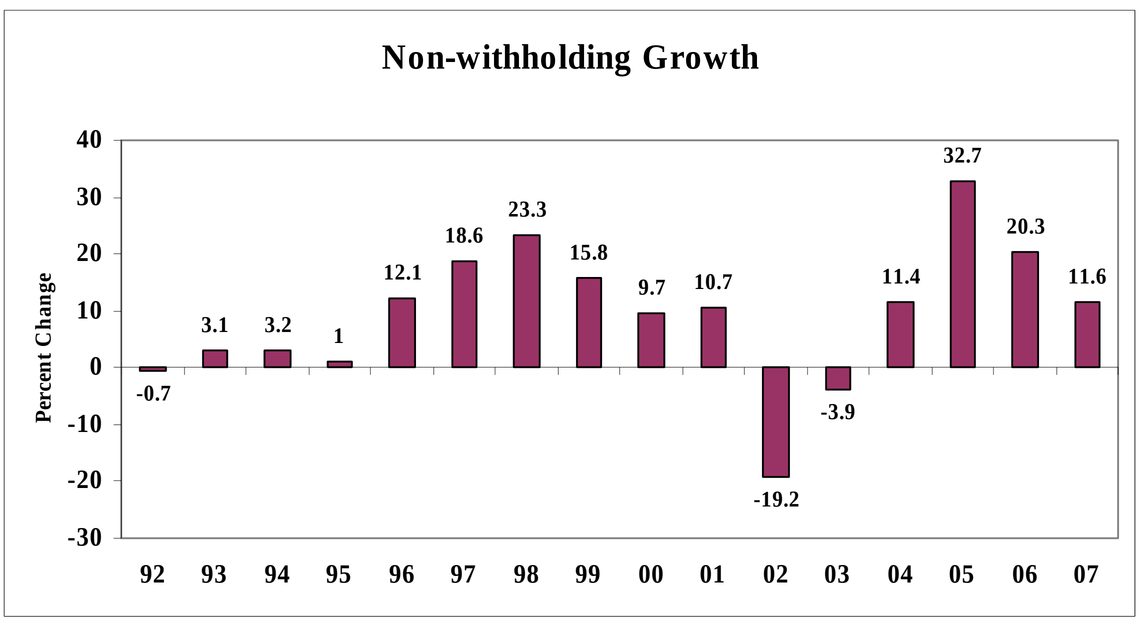
What are the relationships that drive the forecast?

- The self-employed pay two-thirds of ***non-withholding*** based on proprietor's income/bonuses (correlated with corporate profitability), dividend/interest earnings and capital gains from investments.

  - Examples: Lawyers and doctors (if not incorporated); construction contractors/subs; independent tradesmen; real estate agents; direct sellers; some consultants.

- Revenue projection is based on components of personal income and S&P 500 (proxy for investment earnings).

- **Deep and protracted housing downturn should depress growth over next two years**.



Virginia's Revenue Outlook: Looking Ahead to FY 2008-10. . .

What are the relationships that drive the forecast?

- *Corporate* profitability is a function of both business income (general economy driven by consumer demand) and investments.

- But corporations have two tools that make revenue projections less straight-forward:

  - Sophisticated tax planning, i.e., WalMart REIT (If the feds allow a business practice, it flows through to Virginia).

  - Ability to carry back losses and reclaim amounts previously booked as "surplus" through refunds.

- Corporate income tax should be less affected by the housing downturn than non-withholding.

  - Housing-related businesses comprise only 8 percent of corporate tax collections.

- However, **consistent with a slowing economy, corporate growth should be in the moderate, single digit range in the next biennium, unless the economy slips into recession**.

Virginia's Revenue Outlook: Looking Ahead to FY 2008-10. . .

What are the relationships that drive the forecast?

- *Recordation tax* receipts are a function of sales volume and sales price:

Fiscal Year	Sales Volume	Average Sales Price
2006	-9.0%	+17.0%
2007	-17.7%	+0.5%
2008 (July-September)	-17.0%	-1.4%

- The current housing downturn is the most protracted in history; through September, Virginia home sales have declined for 24 straight months relative to prior year.

- It is expected to take 12 to 18 months for the housing market to correct nationally.

  - Good news: To date, statewide sales prices have not shown a large decline; average price appears to be stabilizing in parts of NOVA (July-September).

Fairfax/Falls Church/Arlington/Alexandria	+3.3%
Prince William	-7.3%
Dulles area	-1.3%

  - Bad news: Drop in sales volume accelerated over the quarter with September sales down 24.4 percent; also, pending home sales dropped 25.0 percent (indicator of future activity).

Virginia's Revenue Outlook: Looking Ahead to FY 2008-10. . .

What are the relationships that drive the forecast?

- More bad news: Downward pressure on home prices will intensify with extremely high inventory, increased foreclosures, tighter credit that reduces pool of buyers, and builder discounts.

- **Recordation taxes should remain essentially flat for FY 2009, after an expected drop of 11.5 percent in FY 2008, with a return to single-digit growth in FY 2010.**

Putting it all together . . .

SFC Staff Revenue Estimate
(Economic Growth Rates)

Growth Rates:	FY 2008	FY 2009	FY 2010
Withholding	6.5 %	5.5%	6.0%
Sales Tax	3.2%	5.0%	6.0%
Non-withholding	7.6%	6.6%	7.6%
Corporate	(7.5%)	5.5%	6.0%
Wills, Suits, Deeds	(11.5%)	1.6%	6.1%
GF Economic Growth Rate	**4.7%**	**5.4%**	**6.1%**

Virginia's Revenue Outlook: Looking Ahead to FY 2008-10. . .

- However, tax policy adjustments will lower the economic growth rate:

Tax Policy Adjustments
$ in millions

Base adjustment:	FY 2008	FY 2009	FY 2010
Land preservation credit "overhang"	($50.0)	($75.0)	($20.0)
Elimination of estate tax	($35.0)	($140.0)	($140.0)
Raise filing threshold; PE = $930	($13.5)	($27.0)	($26.9)
Recordation to transportation		($58.1)	($61.6)
Insurance premiums to transportation		($146.8)	($154.1)
Miscellaneous other	($5.6)	($5.7)	($5.1)
GF Tax Policy Adjustments	**($104.1)**	**($452.6)**	**($407.7)**

SFC Staff Revenue Estimate
After Tax Policy Adjustments
($ in millions)

	FY 2008	**FY 2009**	**FY 2010**
Total GF Revenues	**$16,128.8**	**$16,666.9**	**$17,766.5**
GF Growth Rate	**3.6%**	**3.3%**	**6.6%**

- Estimate is built from Global Insight's Standard forecast (slower growth for several quarters).

Virginia's Revenue Outlook: Looking Ahead to FY 2008-10. . .

- Circling back to an earlier point, this may be too optimistic: The revenue forecast rests heavily on projected wage/salary and income growth . . . which in turn is linked to projected job growth.

  - Dilemma: In a slowing economy, job growth is overstated, which means that wage/salary and income projections get inflated.

- Case in point –
  - Initial report of August jobs = 4,000 decline
  - Revised report of August jobs = 93,000 gain
  - Average for July/August/September = 94,000 gain (down 25% from previous 3 months)
  - **Report for October jobs = 166,000 gain**

- **Is it believable** that October job growth would be 75 percent higher than the latest 3-month average, when it is widely felt the economy is weakening?

- Most likely, job count revisions will ultimately show that job growth is weaker than reported.

  - Softening demand for temporary workers supports this conclusion.

Virginia's Revenue Outlook: Looking Ahead to FY 2008-10. . .

- **Why are the job reports unreliable?**

  - Bureau of Labor Statistics (BLS) predicts job growth through a business survey and a household survey.

  - The business survey does not adequately represent small business activity (where most of the jobs in economy are added or lost).

  - A statistical adjustment is applied that attempts to compensate by estimating small business jobs gained and lost; however, it is backward looking (**based on historical data**).

  - Therefore, it understates the job count in an expanding economy and **overstates the job count in a contracting economy**.

  <u>Caveat noted on BLS website</u>:

  "The most significant potential drawback to this or any model-based approach is that time series modeling assumes a predictable continuation of historical patterns and relationships and therefore, is likely to have some difficulty producing reliable estimates at economic turning points or during periods when there are sudden changes in trend."

- Statistical adjustment for October = 103,000 jobs.

Virginia's Revenue Outlook: Looking Ahead to FY 2008-10. . .

<u>Other signs of a fragile economy</u>:

- Aftershock of this year's "sub-prime meltdown" is still unfolding.

  - Tighter credit for all types of customers.

  - Financial institutions have started to aggressively book losses from mortgage-backed securities; but more is to come.

  - Credit exposure has moved to bank balance sheets through liquidity backstops, bridge loans for leveraged buy-outs, and forced "parking" of risky loans that couldn't be sold once market froze.

  - Lax lending standards also extended to some business loans for leveraged buy-outs; that shoe may yet fall.

- Housing slide will continue for some time.

  - Home sales are moving toward a 50 percent decline from the peak.

  - Record-high inventory will constrain new construction.

Virginia's Revenue Outlook: Looking Ahead to FY 2008-10. . .

- Foreclosures continue to rise.

  --Even Virginia which is on the low end of sub-prime lending activity reportedly was in the middle tier of states on properties moving toward foreclosure in most recent quarter.

- Owner resistance to price reduction will lengthen recovery period for existing home sales.

  -- Regardless of owner resistance, some predict that home prices ultimately will be pushed down by 10-20 percent in markets that have been highly speculative (Virginia seems to have escaped this phenomenon).

• Consumers are being squeezed.

- Rising gas prices -- Economy.com says "$100 oil implies $4 per gallon gasoline by next summer."

- Rising commodity prices will eventually push up food costs; Labor Department recently reported double-digit increases in some staples.

- Credit card companies are requiring larger minimum monthly payments;

Virginia's Revenue Outlook: Looking Ahead to FY 2008-10. . .

- Those who chose exotic mortgages with delayed payment options will see substantially higher mortgage payments (some prime borrowers also have exotic mortgages).

  -- Price discounting by builders affects the assessed value of property in an area; the prospect of paying several hundred dollars more a month for a property that has lost a chunk of its value poses an interesting choice for the prime borrower who is not at risk of losing his home.

- Consumers can no longer use home equity to bail themselves out.

  - Flat or falling home prices and tighter lending standards limit equity withdrawal.

  - Former Fed chairman Greenspan estimated that equity withdrawal in recent years supported up to 2 percent of spending (3 percent if paying down credit card debt is counted).

  - It's possible that "middle America" was not only buying more "stuff" with this equity but was using some of it for monthly living costs.

Virginia's Revenue Outlook: Looking Ahead to FY 2008-10. . .

Signs of strength in the current economy:

- Corporate cash position remains good and could be used as a backstop for slower revenue growth.

- Exports are very strong, which is good for Virginia because of its superior port facilities.

  - But, exports are only 12% of the U. S. economy.

- Federal spending is still high, mainly because of war.

How does it balance out?

- By far, the downside risks to the economy outweigh upside potential (FY 09 probably most vulnerable).

  Job growth weaker than reported;
  Tighter credit;
  More shoes to drop from lax lending;
  Consumer faces multiple challenges.

The unfortunate reality is . . .

At the point that you know you're in trouble . . . . you're in trouble . . . . caution is even more important going forward.