National/Global Economy

- The economic picture has become clearer and uglier.

  - Last fall, most economists predicted very low growth over several quarters (no recession).

  - Kathleen Camilli, last year's Senate Retreat speaker, voiced the opposite view that the economy already was entering recession.

  - This fall, most economists agree that we have been in a "slow motion" recession – probably since the beginning of 2008.

  - Over the past two months, the melt-down in financial markets and the resulting credit freeze have pushed the recession into "high gear."

    - Loss of confidence; self-reinforcing downward spiral; red ink and panic spreading globally;
    - Multiple waves of government intervention; may take a while to work; contributes to fear;
    - Credit remains tight; sharp pullback in consumer spending;
    - Businesses retrenching;
    - Large job losses nationally; Virginia job growth has slowed dramatically.

- A deeper recession, lasting several quarters is now the most likely scenario.

Virginia's Revenue Outlook

- Revenue reductions made during the 2008 session were based mainly on the Standard national outlook, with select components of less optimistic outlook (low growth in FY 08 and FY 09 with a rebound in FY 10).

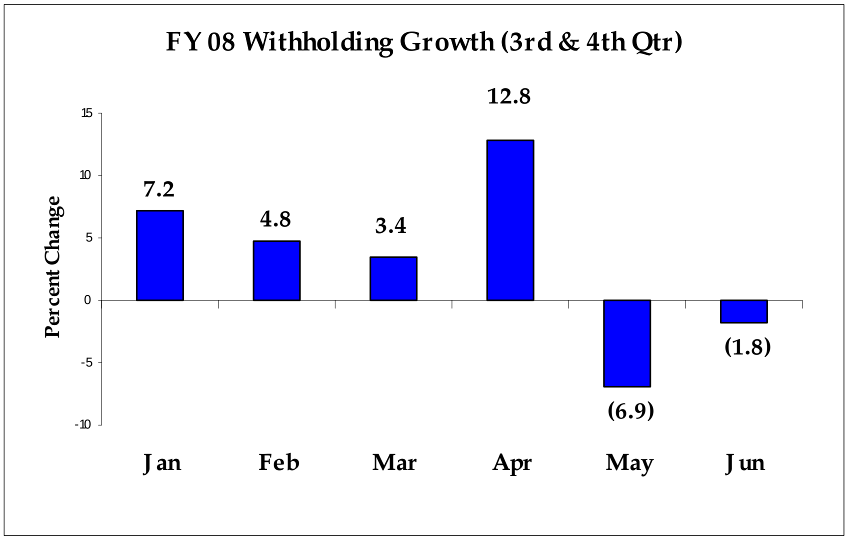
	FY 2008 $ in millions	FY 2009 $ in millions	FY 2010 $ in millions
Revenue Adjust.	($747)	($1,002.5)	($898.9)
Growth rate	**1.3%**	**2.0%**	**6.8%**

Economics Underlying Forecast

	Job Growth	Average Wage/Salary Growth	Income Growth
FY 2008			
Official	1.1%	4.0%	5.2%
Revised Oct	.9%	3.4%	4.8%
More likely	.5%		
FY 2009			
Official	1.0%	3.7%	5.4%
Revised Oct	(0.1)%	3.4%	3.2%
More likely	(0.6)%		
FY 2010			
Official	1.8%	4.0%	6.2%
Revised Oct	0.8%	3.6%	3.7%
More likely	(1.0)%		

Virginia's Revenue Outlook

- FY 08 revenue met the forecast; however, a dramatic drop occurred in May and June withholding payments.



  - YTD performance at the end of April was 6.1 percent – ahead of the forecast of 5.2 percent.

  - Job growth weakened in May and June; average year-over-year growth reported for months of January through April was 18,000 jobs; growth dropped to 12,000 for May and June (job numbers likely are overstated).

- FY 08 job growth fell short of the estimate, creating a negative ripple effect on the 2008-10 biennial revenue forecast; in addition, the September/October financial market implosion carries a heavy down-side risk.

Virginia's Revenue Outlook

- A revised revenue forecast was released on October 9 that assumes a negative adjustment of $2.5 billion.

October Forecast	FY 2009	FY 2010
Withholding	(274.6)	(458.3)
Non-withholding	(422.1)	(653.8)
Refunds	(8.1)	(41.2)
Sales	(150.2)	(237.3)
Corporate	(21.1)	(11.5)
Recordation	(33.5)	(67.8)
Insurance	(37.3)	(34.2)
All Other	(9.5)	(10.9)
Total GF Revenues	($956.4)	($1,515.0)
Transfers	(17.2)	(25.1)
Total General Funds	**($973.6)**	**($1,540.1)**

- Several factors suggest that the $2.5 billion negative adjustment is understated:

  - It is based on the August national data; conditions have deteriorated since August.

    - The Global Insight **October Standard** forecast assumed a 3-quarter recession (that was the pessimistic alternative in August that equated to a $3.0 billion adjustment).

    - The Global Insight **November Standard** forecast now assumes a 4-quarter recession.

  - The October 9 forecast assumes virtually no job loss for Virginia during the downturn.

Virginia's Revenue Outlook

- It may be instructive to look at performance during the two most recent recessions.

	1991 Recession	2001 Recession	Current Situation
Duration	2 quarters	4 quarters*	3-5 quarters?
Consumer action	Pulled back	Kept spending	Pulling back
Revenue reductions	2 sessions	3 sessions	2nd session
$ amount reductions	$2.1 billion	$4.1 billion	$4.4 billion (Oct 9)
% of original forecast	16 percent	16 percent	12.5 percent
Net Job losses	65,000	45,000	None assumed
GF revenue growth	See below	See below	See below

* Officially labeled a 2-quarter recession, but updated data suggests actually was 4 quarters.

<u>1991 Recession</u>

GF Revenue Growth Rates (economic-based):

FY 90	0.3 percent	
FY 91	(0.4 percent)	
FY 92	2.8 percent	
FY 93	9.1 percent	

<u>2001 Recession</u>

GF Revenue Growth Rates (economic-based):

FY 01	2.9 percent	
FY 02	(5.2 percent)	
FY 03	2.9 percent	
FY 04	9.5 percent	

<u>Current Situation</u>

GF Revenue Growth Rates (economic-based):

FY 07	4.2 percent	
FY 08	1.7 percent	
FY 09	(1.9 percent)	Oct 9 Revised forecast**
FY 10	3.6 percent	Oct 9 Revised forecast

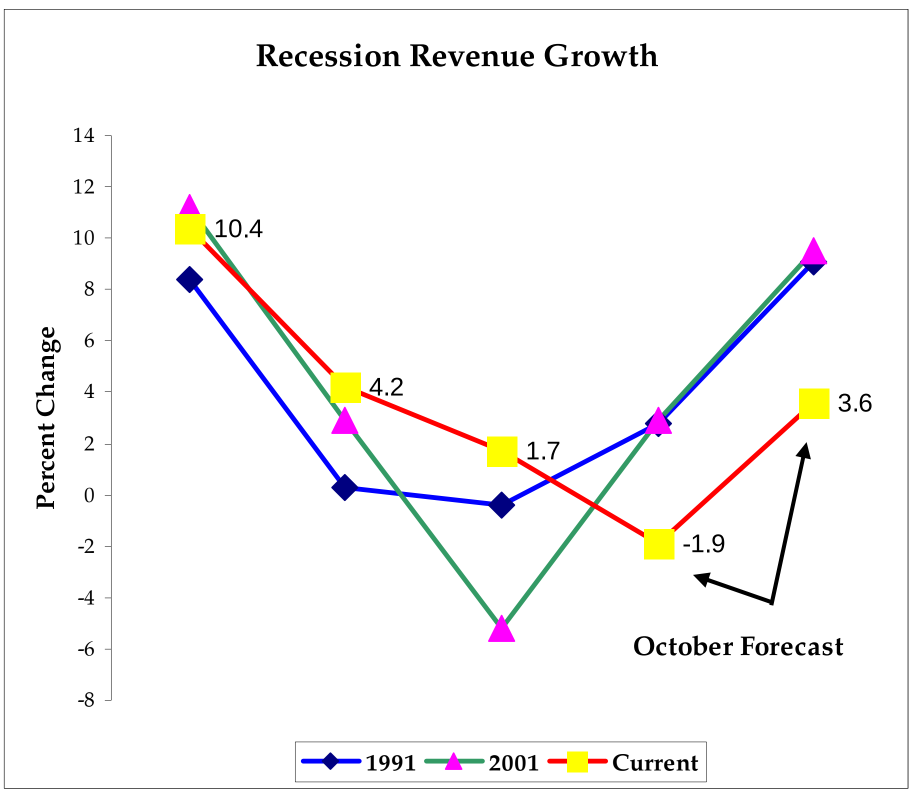
** (4.0 percent) when new tax policy changes are included.

Virginia's Revenue Outlook

- To this point, the current situation has been described as a "U" shaped recession (gradual descent/bump along bottom for some period/gradual ascent), as opposed to a "V" recession (rapid descent/rapid ascent).

  - It is unclear how the panic of the past two months will affect this pattern, i.e., economy was in the "U" when shock caused sharper contraction.

  - However, the FY 10 growth rate in October 9 forecast appears to be steeper than either a "U" or modified "U" pattern would suggest.

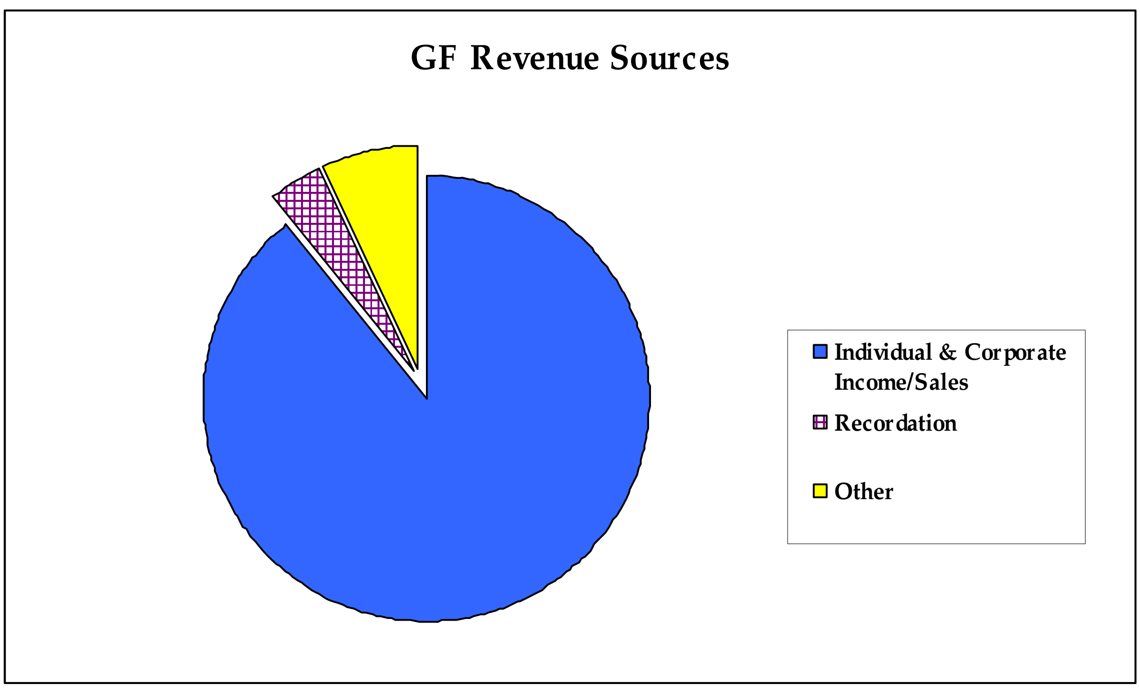


Virginia's Revenue Outlook

- The key to the accuracy of Virginia's revenue forecast is projected income measures (employment, average wage/salary and total income growth).

- Almost 90 percent of GF revenue links back to how many people are employed, what they are paid, and how much disposable income they have to spend.

  - Corporate income tax is indirectly related to income measures because consumer spending and business activity go hand-in-hand.



Virginia's Revenue Outlook

- Employment warrants a special look in the October 9 revised forecast which assumes a decline of 0.1 percent in FY 09.

  - 55 percent of Virginia jobs are in Northern Virginia and Hampton Roads; 45 percent of jobs are in the balance of state.

    -- The October 9 forecast assumes net job losses in the balance of state with the only area of projected growth being Education and Health (13 percent of jobs).

    -- The forecast assumes slight job growth in NOVA and Hampton Roads, driven largely by the assumption that Business and Professional Services jobs (22 percent of jobs) **will grow 5.2 percent in FY 09, up from 2.7 percent growth in FY 08**.

  - This assumption about Business and Professional Services jobs may be optimistic in the current climate.

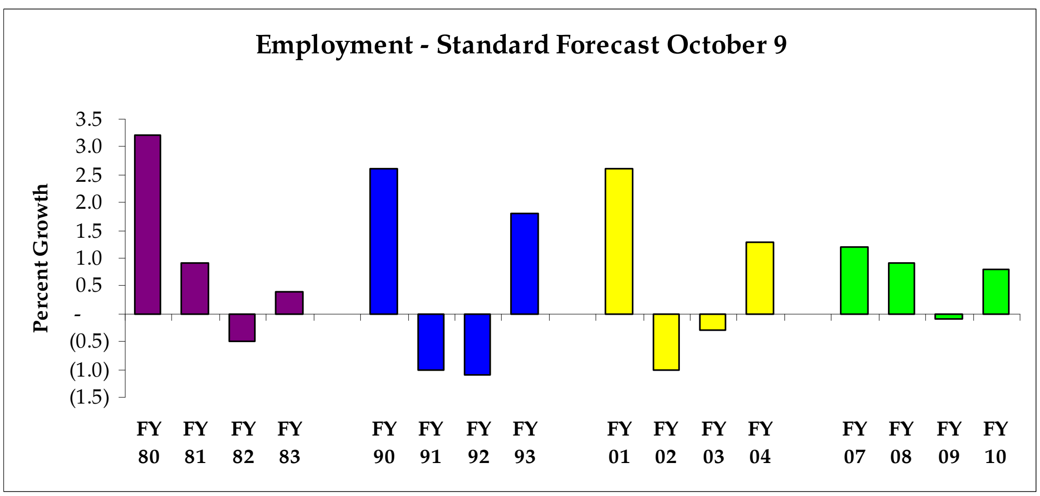
  - More importantly, over the two years of the biennium, the October 9 forecast assumes **a net job gain**, which is inconsistent with Virginia's previous recession experience.

Virginia's Revenue Outlook

- The following chart compares the October 9 Standard forecast employment growth with prior recession experience.

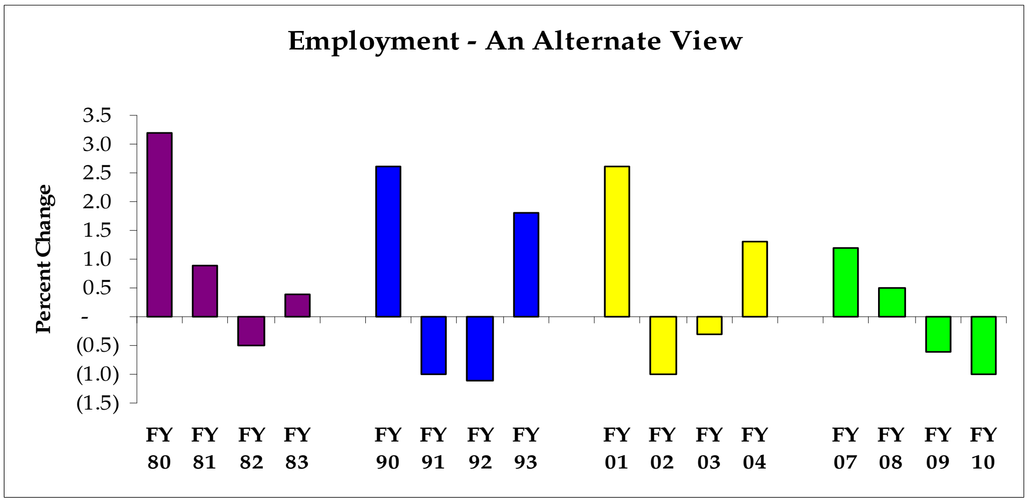
  - Virginia's employment mix is different from the early 90's; roughly 6 percent of jobs have migrated from manufacturing to Business and Professional Services/Education and Health, providing more job stability.

  - However, with weakness in all other sectors, and recent acceleration in retail and service job losses, it may be optimistic to assume that Virginia can avoid net job losses altogether during the recession.



Virginia's Revenue Outlook

- The following chart may be a more realistic view of job performance in Virginia during a recession that is increasingly being described as deep and protracted.



- The alternative assumes net job loss of .6 percent for FY 2009 with most job losses coming in the second half of the fiscal year (however, YTD withholding growth of 5.5 percent will begin to soften starting in November).

- The alternative assumes Global Insight's November low-growth 1 percent net job loss for FY 2010.

- The accuracy of this assumption will depend largely on the strength of defense contracting in Northern Virginia/Hampton Roads, i.e., is it strong enough to outweigh all the other negatives?

Virginia's Revenue Outlook – Case for Caution

- Consumer/business confidence and the ability of consumers to spend is what will turn the economy around.

  - In the current environment, it seems wise to err on the side of caution – consumer and business confidence are both at record lows.

- Consumers can't return to their old spending habits:

  - Home values continue to drop – widespread mortgage equity withdrawal no longer is an option.

  - Credit card delinquencies are rising; credit card lenders have been reducing credit lines, raising interest rates or closing accounts to limit risk.

  - The cost of gas and food is moderating; however, wage increases will not be strong enough to cover remaining inflation and support strong spending.

  - Mounting job losses instill fear in those who still have a job creating a tendency to hold back on discretionary spending.

  - Retirees or those close to retirement will increase savings and reduce spending to help offset mounting losses in their retirement plans.

Virginia's Revenue Outlook – Case for Caution

- Businesses follow the lead of consumers.

  - Manufacturing in the U.S. shrank at the fastest pace in 26 years during October; the non-manufacturing index, which covers 90 percent of the economy, fell to the lowest point in recorded history.

    -- This means job losses not only in manufacturing but also in service industries and retail trade.

    -- Some workers are being required to work fewer hours; this reduces income tax payments but is not reflected in the employment numbers.

  - Businesses will find it hard to borrow for investment (if they even want to) because financial institutions have tightened credit standards (minimizing losses).

  - Businesses needing to refinance old debt in the months ahead will face higher financing costs.

- Areas that have "softened the blow" are weakening.

  - Export growth will reflect a weaker global economy.

  - Commercial construction has now joined residential construction as a drag on the economy.

Virginia's Revenue Outlook – Case for Caution

- The growing federal deficit will force slower growth in federal spending at some point; Virginia is a major beneficiary of federal procurement spending.

- Wall Street may stabilize, but businesses will not invest and add jobs until the man on the street signals the desire and ability to spend again.

  - Clearly, there is more downside risk than upside potential in the current climate; this argues for increased caution in the revenue forecast.

Virginia's Revenue Outlook

SFC Staff Revenue Estimate
(Economic Growth Rates)

Growth Rates:	FY 2008 (Actual)	FY 2009	FY 2010
Withholding	4.3%	3.0%	2.1%
Sales Tax	0.9%	(1.8%)	1.0%
Non-withholding	2.8%	(9.3%)	(2.6%)
Corporate	(8.2%)	(15.4%)	4.3%
Wills, Suits, Deeds	(21.7%)	(20.0%)	(9.5%)
GF **Economic** Growth Rate	**1.3%**	**(2.7%)**	**1.2%**

- However, tax policy adjustments lower the economic growth rate for FY 09:

New 2008-10 Tax Policy Adjustments
$ in millions

Revenue adjustment:	FY 2009	FY 2010
Elimination of estate tax	($155.5)	($155.5)
Recordation to transportation	($43.8)	($46.0)
Insurance premiums to transportation	($132.3)	($129.9)
GF Tax Policy Adjustments	**($331.6)**	**($331.4)**

Virginia's Revenue Outlook

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

	FY 2009	FY 2010
Total GF Revenues	**$14,966.7**	**$15,144.3**
GF Growth Rates	(5.1%)	1.2%
Required Revenue Changes:		
Withholding	($317.6)	($722.7)
Non-withholding	(467.8)	(795.1)
Refunds	(29.3)	(16.4)
Sales	(205.7)	(341.1)
Corporate	(27.4)	(19.1)
Recordation	(56.2)	(130.7)
Insurance	(18.3)	(26.1)
All Other	(.9)	5.4
Total Revenue Changes	($1,123.2)	($2,045.8)
Transfer change (1/4 percent sales tax)	(22.5)	(34.1)
Total Revenue and Transfers	**($1,145.7)**	**($2,079.9)**

- Total recommended biennial revenue adjustments are $3.2 billion.

- If it is felt that a four-quarter recession is more likely than a three-quarter recession, an additional amount set aside as a "safety factor" may be warranted.