2010 Session Budget and Revenue Outlook

Senate Finance Committee
November 19-20, 2009

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

- The national economy has undergone a contraction that is more pronounced than any since the 1930's.

  - Twice as long as the "typical" post-war recession; three months longer than previous record in 1981, if recession "officially" ended in July 2009.

  - Largest consecutive quarterly decline in GDP.

- Both the national and Virginia unemployment rates are approaching levels reached in the early 1980's.

- The national unemployment rate stands at 10.2 percent (Virginia = 6.7 percent) and is expected to grow into CY 2010.

  - The national rate goes to 11.6 percent (Virginia = 7.7 percent), if those who have given up the job search are counted.

  - Another 5.9 percent of the national workforce is in a part-time job for economic reasons (number of workers that equates to about 65 percent of the unemployed versus about 60 percent of the unemployed in 2006, before the economy started to decline).

  - A similar statistic for Virginia is 4.9 percent of the workforce.

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

- The fallout from this recession was particularly harsh because panic became an element.

- It became clear that the financial system was too highly leveraged, based on flawed models and over-valued assets that were "buried" – no one knew exactly where.

    - Mortgage delinquencies spiked.
    - Housing market collapsed.
    - Giants in the financial sector teetered.
    - Stock market took a dive.
    - 20 percent of net worth disappeared through Q1, 2009 (now down 17 percent). Source: Federal Reserve
    - Businesses slashed jobs quickly.

- Aggressive monetary and fiscal policy followed to curb the panic and provide <u>a bridge to natural stability</u>.

    - One quarter of positive economic activity has occurred; however, it rested almost entirely on temporary monetary and fiscal polices.

        -- Housing: Fed mortgage purchase; low interest rates; Homeowner Tax Credit.
        -- Sales: Cash for Clunkers.
        -- Manufacturing: Inventory rebuilding.

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

- When it comes to longer-term, sustainable economic growth, consumer activity will be the key.

- Yet, the consumer remains badly shaken and has kept his pocketbook closed.

  - Debt no longer is freely available (through home equity and credit cards) to support a lifestyle that lower and middle income families can't afford when their incomes stagnate.

    -- Nationally, real median household income was the same in 2007 as it was in 2000; last year, it dropped 3.6 percent. Source: Census Bureau

  - Loss of wealth also gives the consumer pause –

    -- Higher income households recognize that their assets aren't "bullet-proof" – perhaps, tempering the impulse for conspicuous consumption.

  - Households need to rebuild nest eggs and lower monthly debt payments; Bureau of Economic Analysis reports that the personal savings rate has moved up and some wonder if it is headed back toward the 8-10 percent range of the 1980's.

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

- Consumer confidence will not return until there is ample evidence that the job market is turning around; layoffs are slowing, but when will hiring begin?

- Net new jobs are not expected to be added until the middle of next year – a number of factors could slow job growth.

  - Continuing tight credit for small businesses where most new jobs are created.

  - Higher proportion of workers in part-time jobs for economic reasons than the last time unemployment went above 10 percent – adding hours likely will occur before adding jobs.

  - High concentration of job losses in construction, finance and retail – areas where recovery will be slow; some jobs won't come back.

    -- Foreclosures will continue to work against housing inventory correction.
    -- Demand for commercial real estate has fallen.
    -- Finance sector is restructuring.
    -- Banks are not yet out-of-the-woods, e.g., commercial real estate loans.
    -- Many retail businesses have closed.

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

- Until we approach full employment, there will be little pressure to increase wages and salaries.

  - Through the first half of 2009, wages and salaries fell 4.1 percent nationally and 1.1 percent in Virginia.

- The confluence of these factors means the consumer "can't get back in the game" as aggressively as in the recent past.

  - Coming out of the 2001 recession, slow job growth did not hold back the economy because an "artificial" stimulus -- the housing bubble -- put massive amounts of cash into consumers' hands from mortgage equity withdrawal (MEW).

  - At its height in 2005, MEW provided $500 billion for personal consumption, home improvements and repayment of credit card debt.

- Today, there is no comparable "artificial" stimulus to lift GDP growth; in other words, **personal debt will not be our economic engine for the near term**.

  - The Fed has used its horsepower to stop the fall – there is little left for the expansion phase.

- A weak and/or protracted recovery will constrain general fund revenue growth.

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

FY 2009 Results:

- After reducing the FY 2009 general fund revenue estimate by $1.5 billion in the 2009 session, collections still were $298.8 million short of the final forecast.

GF Revenue Source	Percent of Total	Variance $ in millions
Gross Individual Inc.	80%	**(53.8)**
Refunds	(14)%	**(162.4)**
Sales	20%	**(57.5)**
Corporate	5%	**(37.0)**
All other	9%	**11.9**
Total All	**100%**	**$(298.8)**

- Individual refunds increased 17.1 percent, indicating an overpayment of estimated income taxes throughout the year as the economy deteriorated.

- Overall, GF revenues declined by 9.2 percent (7.9 percent, if tax policy changes are not counted).

  - Sales tax collections declined 5.6 percent.

  - In the past 50 years, GF revenues have fallen in only two other years; **the previous record was half of last year's drop.**

Virginia's Revenue Outlook: FY 2010 – The current fiscal year . . .

FY 2010 Outlook:

- After reducing the FY 2010 general fund revenue estimate by $2.2 billion during the 2009 session, an **Interim Reforecast** was issued on August 19th which reduces the estimate by another $1.2 billion.

  - Reforecast assumes employment and wage/salary growth at the midpoint between Global Insight Standard and Pessimistic alternatives (June data).

  - Sales tax growth is the Pessimistic alternative.

  - Corporate growth is slightly above the midpoint between Standard and Pessimistic alternatives.

FY 2010 Interim Reforecast Changes

GF Revenue Source	Percent of Total	$ Reductions in millions
Gross Individual Inc.	80%	**(565.1)**
Refunds	(14)%	**(158.2)**
Sales	20%	**(265.4)**
Corporate	5%	**(61.8)**
All other	9%	**(132.1)**
Total All	**100%**	**$(1,182.6)**

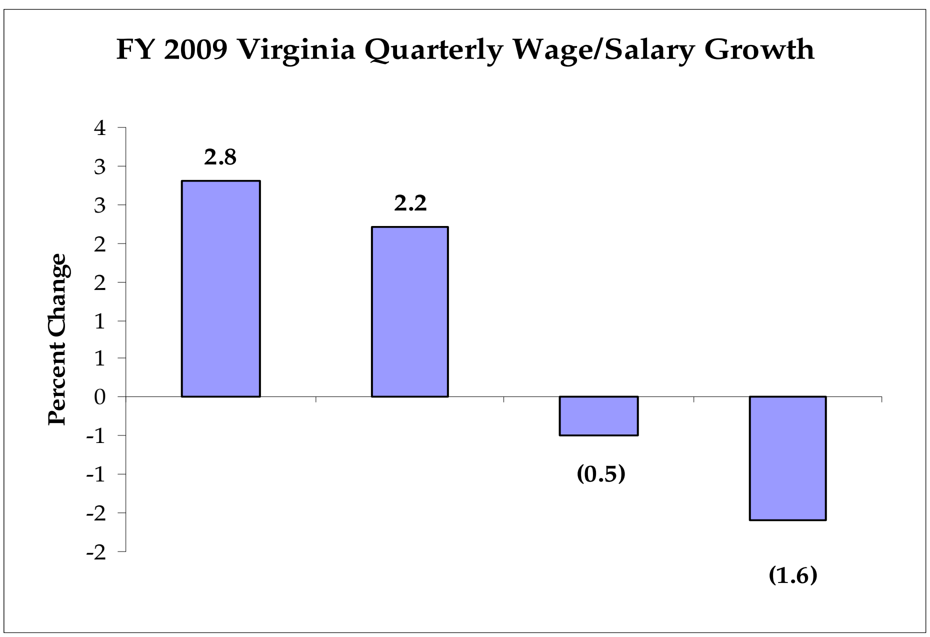
Virginia's Revenue Outlook: FY 2010 - The current fiscal year. . .

- Economic variables underpinning the Interim Reforecast:

Job Growth	Avg Wage and Salary Growth	Total Wages and Salaries (Jobs + Avg WS)	Income Growth
(1.8)%	3.1%	**1.3%**	0.5%

  - The Wage/Salary assumption is particularly important since it is used to project income tax withholding (two thirds of GF revenue).

- Last fiscal year, wage/salary growth was <u>just 0.7 percent</u>.



  - **Looking back to 1971, Virginia has <u>never</u> before had a negative quarter of wage/salary growth.**

Virginia's Revenue Outlook: FY 2010 - The current fiscal year. . .

- It appears that Wage/Salary growth (jobs + average wage/salary) assumed in the August Interim Reforecast to project withholding collections is too optimistic.

- More realistic job projection:

  - FY 2010, Q1 average job decline is 3.0 percent.

  - After the end of both the 1991 and 2001 recessions, Virginia's year-over-year job change stayed in significant negative territory for 10 months.

  - If Virginia exits the current recession with a pattern similar to the 1991 recession (also had debt, banking and real estate problems), FY 2010 employment would decline by roughly 2.1 percent.

    -- However, more job losses this time are concentrated in construction and finance -- areas that won't turn around quickly.

  - **FY 2010 job decline will likely reach 2.4 percent rather than the decline of 1.8 percent assumed in the Interim reforecast.**

Virginia's Revenue Outlook: FY 2010 - The current fiscal year. . .

- More realistic average wage/salary projection:

  - Average wage/salary growth is decelerating.

  - Public sector payroll is now 25 percent of Virginia wages and salaries.

    -- State and local government = no increase.
    -- Federal civilian = 2010 pay raise likely will be half what was provided in 2009 (2.0 percent versus 3.9 percent).

  - Business/Professional and Health Services are another 25 percent of Virginia's wages and salaries.

    -- The highest private sector salary increases would be expected for these jobs; however, rising unemployment limits wage pressure.

    -- Many private sector employers are expected to put emphasis on non-taxed benefits rather than on wage/salary increases.

  - **Average wage/salary growth may only reach 1.8 percent in FY 2010 rather than the 3.1 percent assumed in the Interim reforecast**.

Virginia's Revenue Outlook: FY 2010 - The current fiscal year. . .

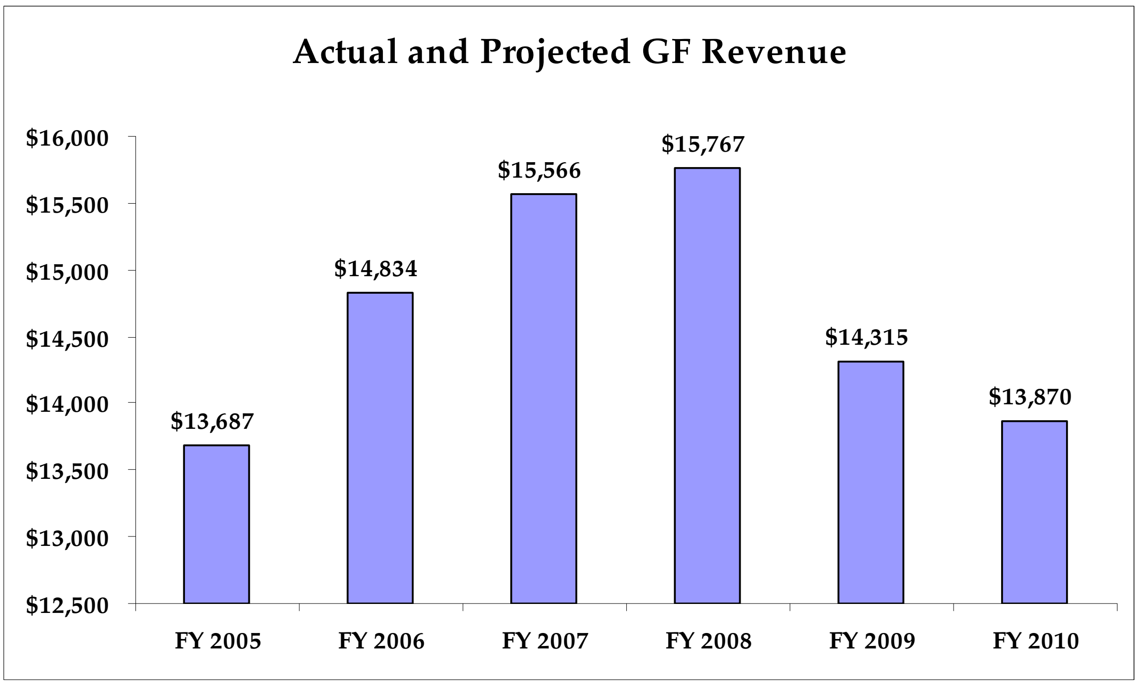
- Revenue collections through October confirm several areas of weakness, including job and wage/salary growth.

GF Revenue Source	Percent of Total	YTD Growth Thru Oct	Interim Est. (Economic growth)
Withholding		**(3.9)%**	2.1%
Nonwithholding		**(24.8)%**	(17.6)%
Refunds		**25.9%**	(1.2)%
Net Individual	66.1%	**(8.6)%**	(2.0)%
Sales	20.5%	**(5.8)%**	(4.1)%
Corporate	4.7%	**(0.1)%**	2.2%
Recordation	2.0%	**(9.2)%**	(9.6)%
Insurance	1.8%	**0%**	0.2%
All Other	4.79%	**(6.3)%**	(6.7)%
Total * $135.8 million in 1-time collections not included	100.0%	**(7.6)%**	**(2.6)%***

- **Recommended revisions to Interim Reforecast:**
  - Reduce Withholding per Wage/Salary discussion;
  - Reduce Corporate to reflect still high refunds;
  - Increase Indiv. refunds to reflect fall extension filers;
  - Increase Recordation to reflect sales volume uptick.
  - Net adjustment = ($209.7) million

Virginia's Revenue Outlook: FY 2010 - The current fiscal year. . .

- With these adjustments, GF revenue collections in FY 2010 will be $13.9 billion – an amount between FY 2005 and FY 2006 collections.



  - FY 2010 collections include a one-time amount of $135.8 million from tax amnesty and a change in the sales tax remittance date.

  - If the one-time funds are excluded, the FY 2010 revenue base will be about $47 million higher than FY 2005.

Virginia's Revenue Outlook: Looking Ahead to FY 2010-12 . . .

- Over 90 percent of GF revenue comes from income and sales tax; therefore, wage/salary and income growth assumptions are central to the biennial forecast.

Projected Economic Variables
(National forecast, adjusted for Virginia specific data)

	Job Growth	Avg Wage/Salary Growth	Total Wage/Salary Growth	Income Growth
FY 2011				
Global Insight Std	**1.1%**	**1.9%**	**3.0%**	**3.3%**
Global Insight Pess	**(0.1)%**	**1.9%**	**1.8%**	**2.3%**
Moody's Econ.com	**0.7%**	**0.7%**	**1.4%**	**1.9%**
FY 2012				
Global Insight Std	2.0%	2.2%	4.2%	4.0%
Global Insight Pess	1.1%	2.2%	3.3%	3.6%
Moody's Econ.com	3.1%	0.9%	4.0%	4.0%

- The turnaround should occur in FY 2011, but timing is elusive.
  - Jobs remain a major concern.
  - Federal stimulus and Federal Reserve easing of monetary policy will begin to reverse in FY 2011.
  - A conservative approach would be to use the low end of growth assumptions in projecting FY 2011 **withholding and sales tax;** standard growth assumptions for FY 2012 appear reasonable.

Virginia's Revenue Outlook: Looking Ahead to FY 2010-12 . . .

<u>Other Major Tax Sources</u>:

- As we enter economic recovery, strength first will appear in **corporate and non-withholding** collections.

  - Corporate profits and proprietor's income – cost cutting has occurred; until companies start to add back jobs and increase business investment, their bottom lines will generate more income tax.

  - Companies exhaust their ability to carry back losses.

  - Some gains from stock market rebound begin to be reflected in tax liability.

- **Refunds** will move down as the economy improves; however they will remain elevated next biennium because delayed land preservation tax credits will start to "catch up" in FY 2012.

- **Recordation tax** receipts will recover, but don't expect double-digit growth.

Fiscal Year	Recordation Tax	Home Sales Volume	Average Sales Price
2006	+9.9%	-9.1%	+17.0%
2007	-16.1%	-17.6%	+0.5%
2008	-22.3%	-19.0%	-2.7%
2009	-23.9%	-2.7%	-12.3%
Q1, FY 2010	-8.6%	-1.0%	-6.0%

Virginia's Revenue Outlook: Looking Ahead to FY 2010-12 . . .

- Virginia's recordation taxes reflect two different waves of negative real estate activity since 2007, with Northern Virginia leading the way.

Region	Sales Volume	Avg. Sales Price
Northern Virginia area and Fredericksburg	Dropped sharply in FY's 2006-2008; Sales increased in FY 2009, due partially to foreclosure sales.	Area led state in price decline, starting in FY 2008. FY 2008 and FY 2009 cumulative decline in average price was about 20 percent in NOVA, about 30 percent in Dulles and Fredericksburg, and over 50 percent in Price William.
Richmond area and Hampton Roads	Large drop began a year later than upstate. Sales still dropping in 20 percent range during FY 2009.	Price decline did not start until FY 2009. Much lower price decline of about 9 percent in Richmond area and about 2 percent in Hampton Roads.

FY 2010, Q1	Sales Volume	Avg. Sales Price
FY 2010, Q1	Sales increased except in Prince William and Dulles (sales down in these two areas because comparing with huge increase in FY 2009, Q1 due to foreclosure sales). Homebuyer tax credit is impacting sales volume.	Slight sales price increase in Dulles and Prince William; slight sales price decline in Northern Virginia area. Prices still falling in Richmond, Hampton Roads & Fredericksburg.

Virginia's Revenue Outlook: Looking Ahead to FY 2010-12 . . .

Observations about recordation tax collections:

- Sales volume appears to have turned the corner; however, some of the increase is related to Homebuyer Tax Credit and the end of program in spring 2010 could affect trend.

- The free fall in home prices in Northern Virginia market appears to be over; however, foreclosures still will have a dampening effect on growth.

- There continues to be softness in home prices in Richmond/Hampton Roads; rising foreclosures in these two areas will further depress prices.

- Commercial real estate will not help recordation tax collections in the next biennium; part of the FY 2009 decline in collections appears to be related to "fall-out" from commercial property.

- Recordation should be on a "normal" growth track by FY 2012.

Virginia's Revenue Outlook: Looking Ahead to FY 2010-12 . . .

Putting it all together . . .

SFC Staff Revenue Estimate

	FY 2010	FY 2011	FY 2012
Withholding	0.3%	1.9%	4.2%
Non-withholding	-17.6%	7.2%	6.4%
Refunds	1.8%	-5.7%	3.2%
Sales Tax	-4.0%	-2.2%*	3.9%
Corporate	-2.5%	14.3%	24.6%
Wills, Suits, Deeds	-4.5%	0.0%	6.5%
Other	-2.1%	0.5%	2.7%
GF Growth Rate	**-4.1%**	**3.3%**	**5.6%**
Adjust for one-time revenue	1.0%		
Net for FY 2010	**-3.1%**		
Total GF Revenues	$13,869.7	$14,327.3	$15,125.2
Transfers	416.9	345.8	355.1
Total GF Revenues Available	$14,286.6	$14,671.3	$15,480.3

***1.5% growth assumed; negative caused by loss of one-time revenue**

- With this growth pattern, FY 2012 GF revenues would slightly exceed actual collections in FY 2006.

Virginia's Revenue Outlook: Looking Ahead to FY 2010-12 . . .

Conclusion –

- The problems that cause a financial meltdown won't get corrected overnight.

- The last time unemployment topped 10.0 percent in the early 1980's, it took five years to return to full employment; it could take longer this time.

  - High concentration of job losses in construction and finance;

    -- Foreclosures will continue to impact housing inventory correction for some time;
    -- Commercial construction will be a drag rather than a boost during this recovery.
    -- Finance sector consolidations mean some jobs won't come back.

  - The overall trauma from the extraordinary events of this past year could make businesses hesitate a little longer than normal.

- Temporary stimuli can push GDP growth into positive territory and "officially" end a recession but the real recovery does not begin until net job growth gets underway.

Virginia's Revenue Outlook: Looking Ahead to FY 2010-12 . . .

- In order to sustain a recovery long-term, the consumer has to "get back in the game."

- The consumer's ability or willingness to be a major player has been compromised.

  - Ability to spend flows from income, access to debt or savings.
  - Americans have been on a long-term debt binge; real income growth for most has been modest.
  - The "artificial" stimulus caused by housing boom allowed debt to be taken to a whole new level through mortgage equity withdrawal.
  - Today, access to credit is limited for some as bankers overcompensate for "sins of the past."
  - Some consumers are trying to pay down debt.

- Income and savings will have to be the primary source of consumption for the near term.

  - Wage and salary growth will be constrained until full employment brings wage pressure.
  - Disposable income can't grow if employees continue to absorb a bigger share of health care costs.
  - The dramatic drop in net worth, including the erosion in home value -- the primary asset of most consumers -- makes them at least think twice before buying something they don't need.

Virginia's Revenue Outlook: Looking Ahead to FY 2010-12 . . .

- We may be at one of those economic "fault lines" where things change permanently -- at the very least, we should acknowledge that for the near-term, the consumer can't be the major driver of growth.

- Something else will have to be the near-term "spark" that gets things going – it isn't clear what that will be.

- There is general consensus that this recovery will be slow and uneven.

- General fund revenue growth in the next biennium will be negatively impacted by the overhang from the worst recession in modern times.