SENATE OF VIRGINIA

Senate Finance Committee

Revenue and Budget Outlook

November 17, 2011

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

- It feels a lot like 2007 – **Excerpt from 2007 Retreat**:

  - *Economic uncertainty has risen sharply since last year.*

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

  - *Fed Beige Book (October, 2007): "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."*

  - *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 <u>recessions occur when low growth rates collide with external shocks or after-shocks</u>****.*

- So, what's different today?

  - Another dip would be milder because there has been no "overheating" since the Great Recession.
    - A lot of workers haven't been rehired, so they can't be re-fired;
    - Large companies are flush with cash to weather another slump; smaller companies have slightly more access to credit;
    - Housing can't get much worse.

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

- But, another difference that is a negative for Virginia is that the federal government no longer will cushion a slowdown, but will add to it.

- Virginia is not expected to outperform the nation in the near term because it relies so heavily on federal spending (#2 per capita nationally).

  - Two-thirds of Virginia's job growth last fiscal year came from Northern Virginia, where federal spending has been a major driver of growth.

- Overall, direct federal spending (Department of Defense and other federal agencies) is about 32 percent of Virginia's gross state product (GSP).

  - But, a smaller proportion is most vulnerable to cuts:

Federal Spending	Va. Rank per capita	Percent of GSP
Procurement	#1	**13.8%**
Salaries/wages	#3	**5.0%**
Grants	#48	**2.9%**
		21.7%

Source: State Policy Reports; Consolidated Federal Funds Report

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

- Federal procurement/payroll is highly concentrated:

Locality	**% of Va. FY 10 Procurement $'s ($58.3 billion)**	**% of Va. FY 10 Salary $'s ($21.1 billion)**
Arlington County	16.7	20.4
Fairfax County	41.6	13.2
Loudoun County	5.9	2.0
P. William County	4.1	3.6
Alexandria	3.5	9.5
Falls Church	1.0	1.9
Manassas City	1.4	.3
	74.3%	50.8%
Hampton	1.7	5.2
Newport News	5.5	6.1
Norfolk	3.8	10.4
Virginia Beach	3.8	3.6
Portsmouth	1.3	3.3
	16.1%	28.5%
Total	**90.4%**	**79.3%**

- Direct procurement and salary spending (areas where Virginia is most vulnerable) contribute 26 and 21 percent, respectively, to the NOVA and Hampton Roads GRP (percentages rise, if add indirect benefit of spending).

- Federal cuts will impact Virginia's budget in two ways:
  - Job losses will reduce revenue.
  - Grant cuts may require some GF supplants.

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

<u>Current condition of economy</u>:

- National economic growth was expected to be sluggish for several years (“financial crisis” recession).

  - However, a year into the recovery, the national economy down-shifted in late spring of 2010, and growth in Virginia began to soften in late spring of this year.

  - Peak to trough, the national economy has regained a quarter of the jobs lost during the recession; Virginia has regained 36 percent. (Source: BLS data, seasonally adjusted)

  - On a year-over-year basis, Virginia has regained 49,000 jobs or about a third of jobs lost.

  - National unemployment rate = 9.1 percent; Virginia rate recently inched up to 6.5 percent.

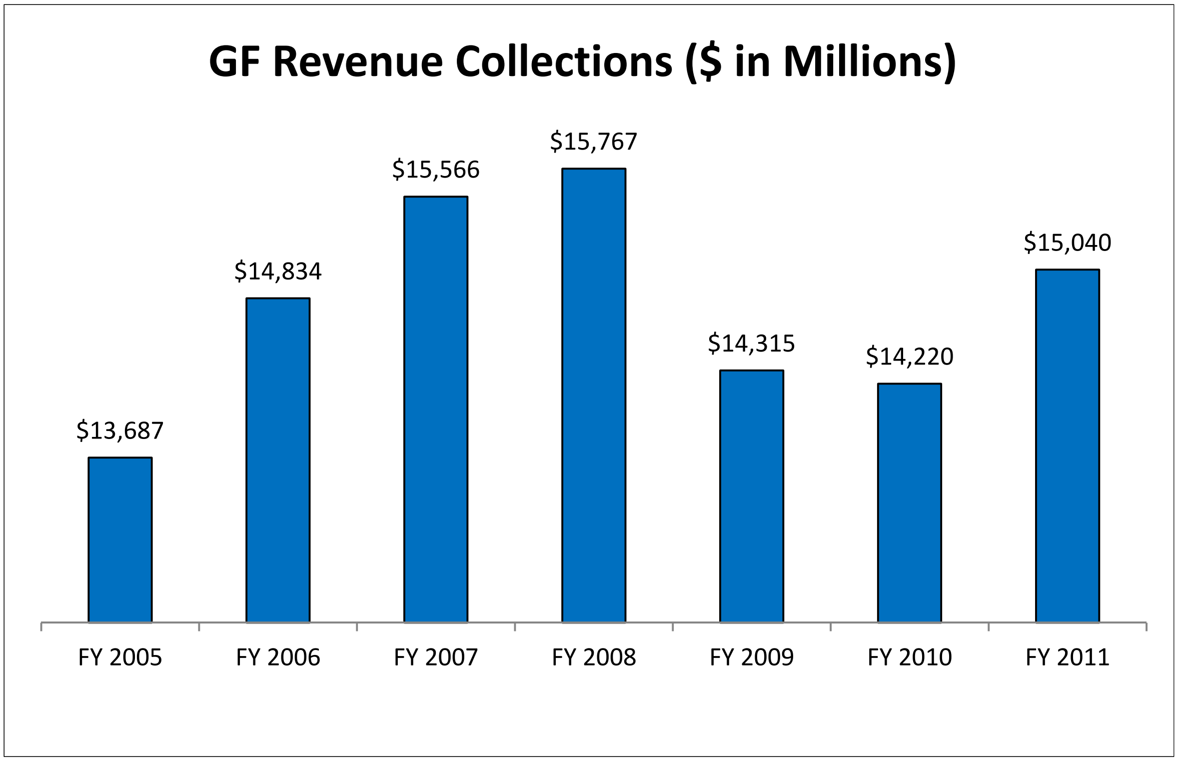
- Bottom line: Standoff continues/ more uncertainty added.

  - Consumers once again are holding back; businesses are waiting them out.
  - European debt situation is not resolved.
  - U.S. fiscal policy is unclear.

Virginia's Revenue Outlook: Performance so far. . .

<u>Virginia's recent performance</u>:

- In FY 2010, Virginia's revenues declined less than projected; in FY 2011, revenues increased more than projected, due to conservative forecasting and slightly better-than-expected economics.
  - FY 2011 revenues grew 5.8 percent, increasing for the first time since FY 2008.
  - Collections were slightly above the FY 2006 level.



Virginia's Revenue Outlook: Performance so far. . .

- FY 2011 performance produced $321.7 million in revenue above the official forecast.

GF Revenue Source	Percent of GF	Variance $ in millions
Withholding	65%	**$ 60.3**
Non-withholding	13%	**110.2**
Refunds	(14)%	**27.7**
Sales	22%	**43.5**
Corporate	6%	**55.7**
All other	8%	**24.5**
Total All	**100%**	**$321.7**

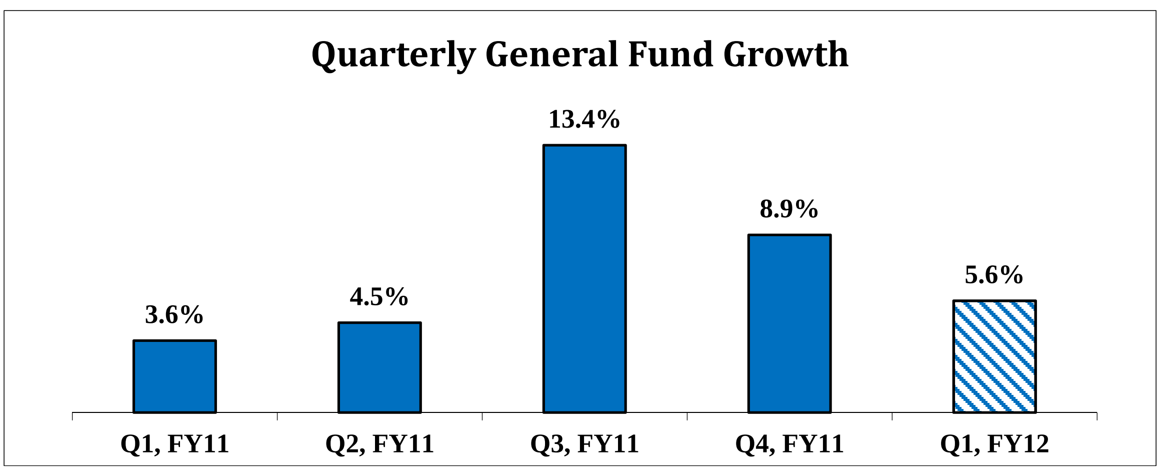
- Roughly $215.0 million of this amount is committed:

Commitment	$ in millions
Rainy Day Fund	**$132.7**
WQIF	**32.2**
TTF accelerated sales tax	**26.0**
Unemployment TF interest	**8.9**
BRAC contingent appropriation	**7.5**
Sheriff contingent appropriation	**7.4**
Total All	**$214.7**

  - Governor proposes $30.0 million for a Federal Action Contingency Fund and the balance for Transportation Trust Fund and repayment of VRS.

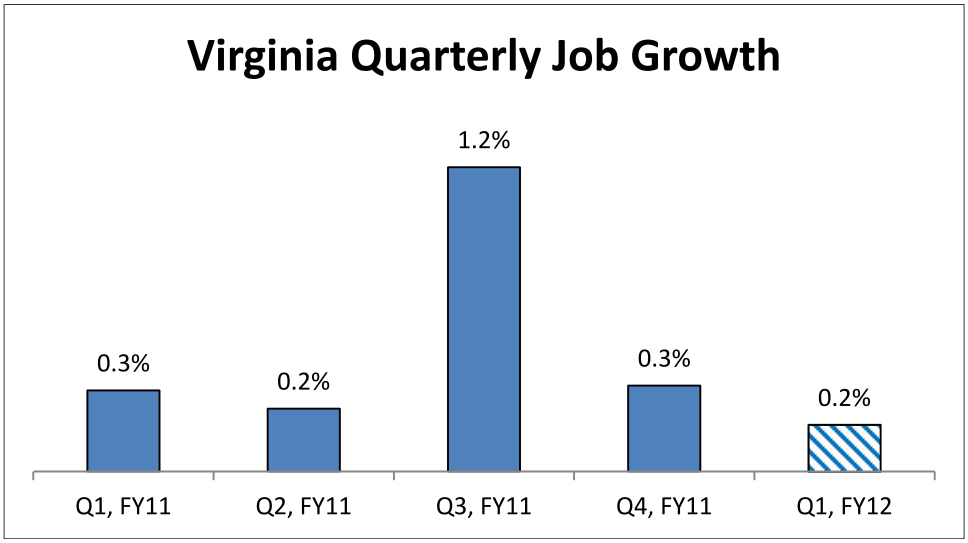
Virginia's Revenue Outlook: Performance so far. . .

- Virginia's revenue forecast for FY 2012 must be adjusted to reflect two partially offsetting factors:
  - Revenue base will be increased by $321.7 million due to FY 2011 collections; and
  - Economic growth rate will be lowered due to recent softening, thereby "eating into" the impact of the $321.7 million.
- FY 2012 budget assumed revenue growth of 5.9 percent.
  - Can meet the official forecast with 3.7 percent growth because revenue base has been increased.
  - That's good, because growth is trending down in that direction.



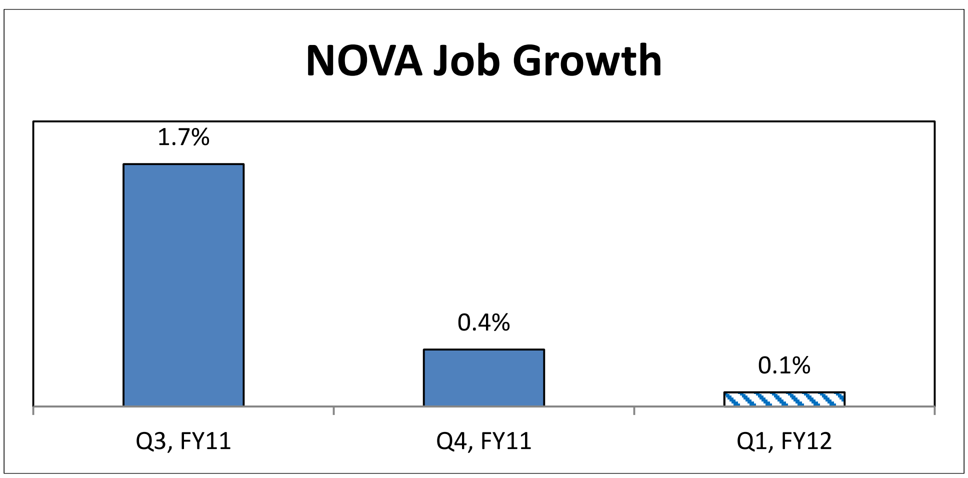
Virginia's Revenue Outlook: Performance so far. . .

- Job growth is influencing that trend.



Source: BLS Current Employment Statistics

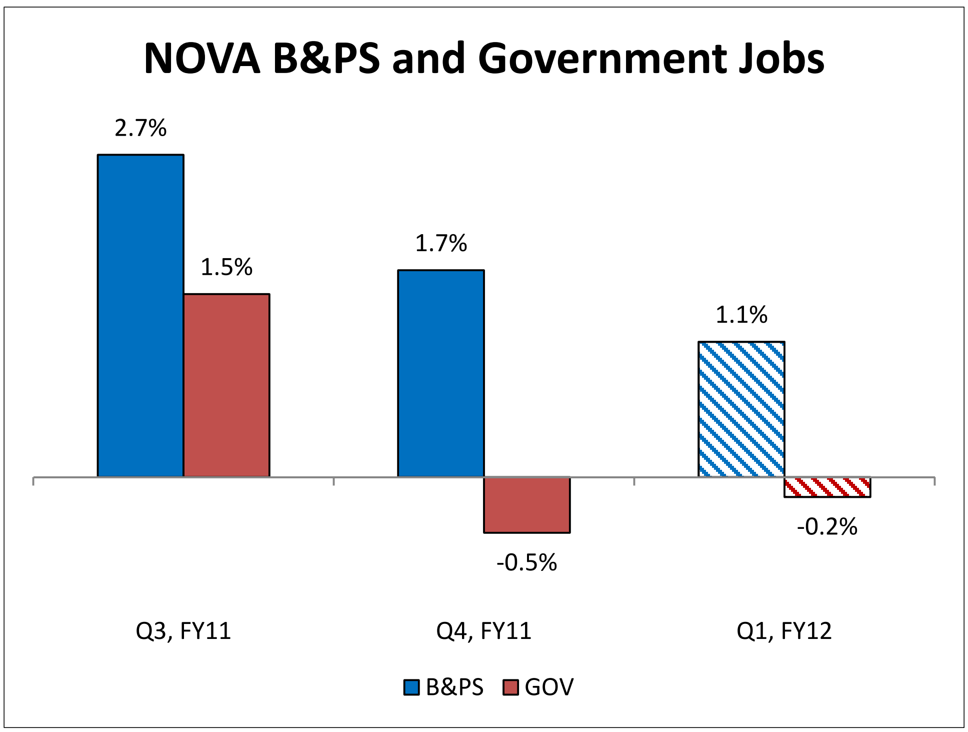
- Slowdown reflects what is happening in NOVA.



Source: BLS Current Employment Statistics

Virginia's Revenue Outlook: Performance so far. . .

- Almost half of NOVA's jobs are Business and Professional Services (B&PS) and Government jobs.
  - B&PS jobs are heavily influenced by federal procurement.



  - It's possible that speculation/fear about what could happen with defense spending already is softening the growth rate in Business and Professional Services jobs.

Virginia's Revenue Outlook: Performance so far. . .

FY 2012, First Quarter Revenue Collections:

- First quarter growth was 6.7 percent against a forecast of 3.7 percent (more meaningful growth rate is 5.6 percent versus 3.5 percent, adjusting for accelerated sales tax).

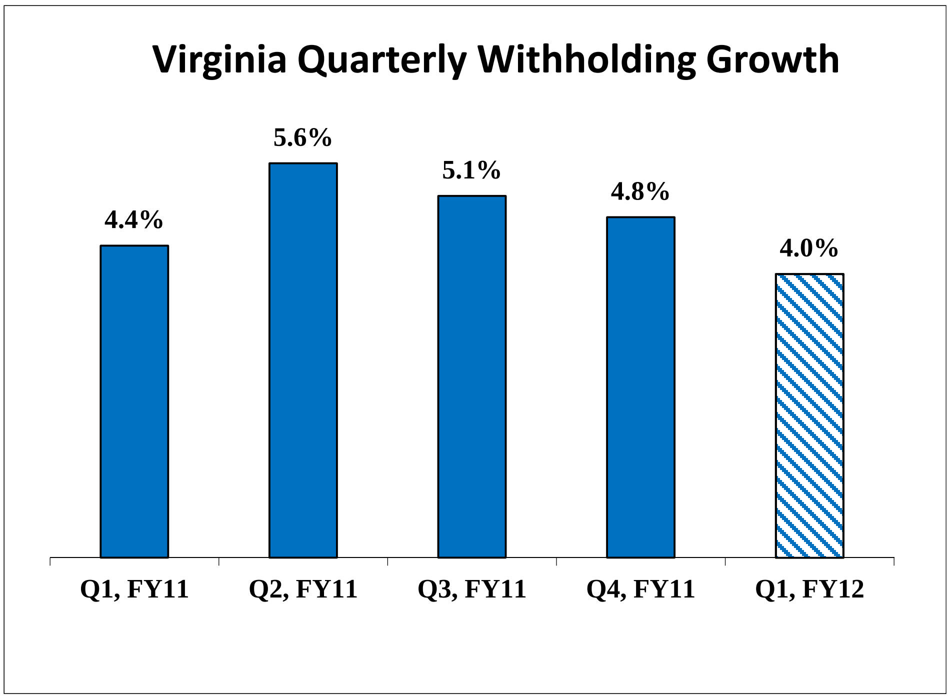
GF Revenue Source	Percent of GF	YTD Growth Thru Sep	Required by Forecast
Withholding	63.9%	**4.0%**	**3.4%**
Non-withholding	14.3%	**18.8%**	**2.1%**
Refunds	(11.9)%	**(14.1)%**	**(0.9)%**
Net Individual	66.2%	**6.8%**	**3.9%**
Sales	20.0%	**7.3%**	**3.4%**
Corporate	5.3%	**7.7%**	**1.1%**
Wills (Recordation)	1.9%	**4.2%**	**3.3%**
Insurance	1.9%	**NA**	**2.9%**
All Other	4.7%	**3.5%**	**5.7%**
Total	100.0%	**6.7%**	**3.7%**
Sales w/o AST		**1.9%**	**2.5%**
Total w/o AST		**5.6%**	**3.5%**

- When October growth is added, year-to-date "economic-based" growth without AST is 5.0 percent.
  - Withholding YTD = 4.3%; Sales w/o AST = 2.1%

Virginia's Revenue Outlook: Modifications to FY 2012 Forecast. . .

Withholding

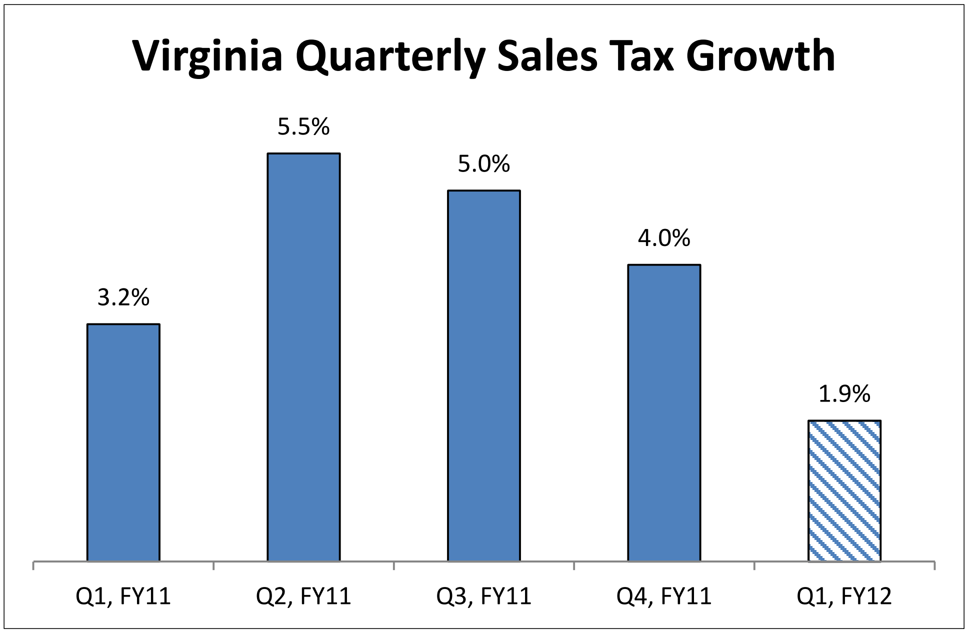
- Q1 withholding of 4.0 percent suggests job growth actually is above the 0.2 percent reported by the Bureau of Labor Statistics (but it definitely has slowed).
- Average wage/salary growth for the year should be about 2.6 percent.
- By year-end, withholding growth should drop below 4.0 percent, due to comparison with relatively strong quarters last year, as shown below.



Virginia's Revenue Outlook: Modifications to FY 2012 Forecast. . .

Sales Tax

- Q1 sales tax growth of 1.9 percent is substantially weaker than last year's first quarter.
  - Collections are weaker than personal income growth would suggest; however, heightened uncertainty and low consumer confidence are weighing on sales.
- By year-end, the growth rate should weaken further, due to comparison against last year's good performance.



Virginia's Revenue Outlook: Modifications to FY 2012 Forecast. . .

Corporate and Non-withholding

- Neither source is showing signs of weakness yet.
  - These two sources are the most volatile and difficult to project; a large part of the collection pattern is driven by taxpayer behavior and tax planning.
  - Stock market performance figures in both sources.
- Q1 corporate growth, which was 7.7 percent, should be sustainable this fiscal year.
- Q1 non-withholding growth, which was 18.8 percent, should decline by year-end, when final payments are compared to last year's 34.0 percent performance.

Recordation Tax

- Q1 growth of 4.2 percent for Wills, Suits, Deeds should be sustainable.
  - FY 2012 sales volume will be positive in comparison to last year's 15.0 percent decline (homebuyer tax credit pulled sales forward into FY 2010).

Virginia's Revenue Outlook: Modifications to FY 2012 Forecast. . .

- Some increase in household formation is expected in 2011, relative to extreme lows in recent years, providing limited growth in multi-family market.

- Refinance activity was a boost last fiscal year, and will continue to help with growth in the near term.

  - Mortgage Bankers Association recently projected that refinance originations will drop about 30 percent each year in 2012 and 2013, as fewer eligible borrowers are left to refinance.

- However, modification of the Home Affordable Refinance Program (HARP) should draw some borrowers into the refinance pool: (1) mortgages backed by Fannie/Freddie before May 31, 2009; (2) not delinquent; and (3) home is worth less than mortgage.

  - Removes the current 125 percent loan-to-value cap;
  - Eliminates some loan origination fees;
  - Extends the program through 2013.

- However, sales price will not add much to the equation.

  - NOVA price increases are offsetting declines that continue in other parts of the state.

Virginia's Revenue Outlook: Turning to the 2012-14 Biennium. . .

- The biennial revenue forecast rests heavily on job and payroll assumptions since almost 87 percent of GF revenue comes from individual income and sales tax.

Projected Economic Variables

(National forecast, adjusted for Virginia specific data)

	Job Growth	Avg Wage/Salary Growth	Total Wage/Salary Growth	Income Growth
FY 2013				
Global Insight Std	1.0%	2.5%	3.5%	3.4%
Global Insight Pess.	(0.3)%	2.3%	2.0%	1.9%
Moody's Econ.com	1.0%	7.1%	8.2%	6.6%
FY 2014				
Global Insight Std	1.8%	2.4%	4.2%	4.0%
Global Insight Pess.	0.9%	1.9%	2.8%	3.0%
Moody's Econ.com	2.4%	4.9%	7.5%	6.1%

Based on October 2011 forecasts

- In general, the Global Insight variables assume:
  - Continued slow job growth;
  - Impact of federal defense cuts already approved (no assumption about sequestration);
  - Modest income growth, by Virginia standards.

Virginia's Revenue Outlook: Turning to the 2012-14 Biennium. . .

Withholding

- Job growth likely will be between the Global Insight Standard and Pessimistic outlooks; however, average wage/salary growth appears to be slightly understated.

- Withholding growth should be in the 4.0 percent range.

  - Growth rates would need to be re-visited, should the national economy enter recession or federal funds be cut through sequestration, **effective January 2013**.

Sequestration – DOD To Take Half Cuts
Another $55-$60 billion/year in DOD cuts
Procurement/DOD civilian payroll most at risk
Virginia #2 in DOD procurement spending (12.2 percent)
Virginia #1 in DOD civilian payroll spending (15.6 percent)

- Per Stephen Fuller, GMU Center for Regional Analysis:

  - $1.0 million in overall DOD spending = 15.6 direct jobs (plus 10.2 from indirect spending in community);

  - Procurement impact of **sequestration** = 25,000 direct job loss (plus 46,000 from indirect spending in community).

Note: Global Insight forecast already includes estimate of job impact from $40+ billion/year of defense cuts approved in August legislation; does not include sequestration.

Virginia's Revenue Outlook: Turning to the 2012-14 Biennium. . .

Sales Tax

- Personal Income growth is the proxy used to project sales tax.

  - Nationally, sales growth has been supported recently from a drawdown in the savings rate.

- Consumption will not be a strong driver of recovery until job growth strengthens and housing no longer is bumping along the bottom.

  - A reasonable approach is to project sales tax for FY 2013 and FY 2014 using Personal Income that is between the Global Insight Standard and Pessimistic outlooks.

Corporate and Non-withholding

- Corporate and non-withholding typically move in the same direction over a business cycle, but not necessarily in the same fiscal year.

  - At turning points, corporate strength or weakness is seen first, with non-withholding lagging a few quarters behind.

Virginia's Revenue Outlook: Turning to the 2012-14 Biennium. . .

- After the dramatic movement at turning points, both settle into "normal" or "sustainable" growth patterns until the next turning point arrives; stock market performance impacts non-withholding more, making it a little less predictable.

  - Corporate collections will settle into the "normal" or "sustainable" mode in the 2012-14 biennium.

  - Non-withholding collections will be lowered in FY 2013, as last year's very strong final payment "corrects"; growth then will stabilize.

<u>Recordation Tax</u>

- Price won't contribute much to growth.

  - Foreclosures have stalled as irregularities in the process are investigated; there still is a large pipeline that has to be cleared, once the matter is resolved.

- Growth in sales volume will be modest, until major housing market constraints are removed.

  - Lack of job growth/low household formation;
  - Tight credit standards;
  - Negative equity.

Virginia's Revenue Outlook:

SFC Staff Revenue Estimate

	FY 2012	FY 2013	FY 2014
Withholding	3.6%	3.7%	4.3%
Non-withholding	6.7%	(1.5%)	8.1%
Refunds	(2.5%)	(1.0%)	2.0%
Sales Tax	3.0%	2.9%	3.4%
Corporate	6.4%	4.5%	0.9%
Wills, Suits, Deeds	4.1%	4.0%	5.0%
Other	4.0%	(0.2%)	2.2%
GF Growth Rate	**4.9%**	**3.1%**	**4.6%**
GF "economic" growth	4.5%	3.2%	4.7%
Sales tax "economic" growth	1.6%		
Total GF Revenues	$15,772.9	$16,265.1	$17,015.7
Transfers (Chapter 890)	$453.6*		
Transfers (normal policy)		$383.6	$391.1
Total GF Resources	**$16,226.5**	**$16,648.7**	**$17,406.8**

*Includes $88 million from various NGF balances, interest earnings, etc.

- Revenue notes:
  - FY 12 revenue = $178.0 million above official forecast.
  - Current dealer discount policy = $49.0 million/year.
  - Accelerated Sales Tax = $28.0 million loss when take next step to unwind (General Assembly to determine timing).

Virginia's Revenue Outlook: Concluding Thoughts . . .

- The most positive thing that can be said about the economy is that it seems to be running in place.

  - Over the fall, a level of apprehension took hold that was reminiscent of recession behavior.

  - Fear related more to debate and disagreement about policy issues at home and abroad than to actual changes in the economy – but fear feeds on itself.

- The reality is that this recovery is particularly fragile because the basic fundamental holding it down – **too many people without jobs** - can't be reversed quickly.

  - Nationally, about 45 percent of the unemployed have been without a job for more than six months.

  - Many recent high school and college graduates are backed up in the pipeline.
    - 18-19 year olds = 23.3 percent without jobs
    - 20-24 year olds = 14.7 percent without jobs

  - Older workers are afraid to let their job go.

  - More veterans will be entering the job market.

Virginia's Revenue Outlook: Concluding Thoughts . . .

- In the meantime, the lack of jobs means limited housing demand and lackluster consumption.

- While Virginia fared better than the nation during the recession, it is not immune to these post-recession realities.

  - In fact, should federal defense cuts occur through sequestration, Virginia will face unique challenges because of its heavy dependence on procurement spending.

- Uncertainty requires that Virginia's revenue forecast continue to be conservative.

  - Provides potential for continuing pattern of revenues above the forecast at year-end;

  - Could lead to more contingent appropriations, in order for the General Assembly to leave its mark on the budget.

Appendix

Refresher on Tax Policy . . .

- Annually, the estimated tax benefit of tax policy changes **enacted or amended since 1990** is updated by the Tax Department, as shown in the following table.

  - The data is a preliminary estimate of what could be claimed; there is no comprehensive after-the-fact annual report on all tax preferences claimed.

- Earlier this week, JLARC staff delivered a Commission briefing (draft report is on website; report will be authorized for printing in December) that looked at actual tax preferences claimed in 2008, and proposed a method to evaluate the effectiveness of preferences. Key findings:

  - Tax preferences with public policy goals reduce taxpayer liability by $2.9 billion;
  - Preferences providing financial assistance achieve goal, but some may not efficiently reach targeted beneficiaries;
  - Preferences promoting preservation activity achieve goal, but most promoting other activity experience mixed results;
  - No consistent mechanism currently exists to inform the legislature about the effectiveness of tax preferences;
  - Legislative joint subcommittee could oversee tax preference evaluations to enhance effectiveness.

Refresher on Tax Policy . . .

Evolution of Tax Policy

- During the 1990's, a large number of tax preferences were established, sometimes without overall upper limits or performance triggers.

- More recently, tax policy has migrated toward performance grants or "post-dated" tax credits, i.e., the credit can't be claimed until after job growth occurs.
  - More transparency/accountability;
  - Better able to tailor preference to desired outcome;
  - Companies with no tax liability can use grants.

- Common features of recent tax legislation:
  - Grants/credits have overall cap, either per taxpayer or statewide;
  - If statewide cap, apply for allocation in advance;
  - Job creation credits have a set amount per job, i.e., $700 - $1,500, depending on program;
  - If not job specific, credit is a percent of private investment, generally in the range of 25 to 50 percent (performance grants typically are a smaller percent of the private investment).
  - Benefit is required to be claimed in equal installments over several tax years to ensure that positive results accrue to the state in sync with the tax preference.

2012-14 Biennial Budget Outlook

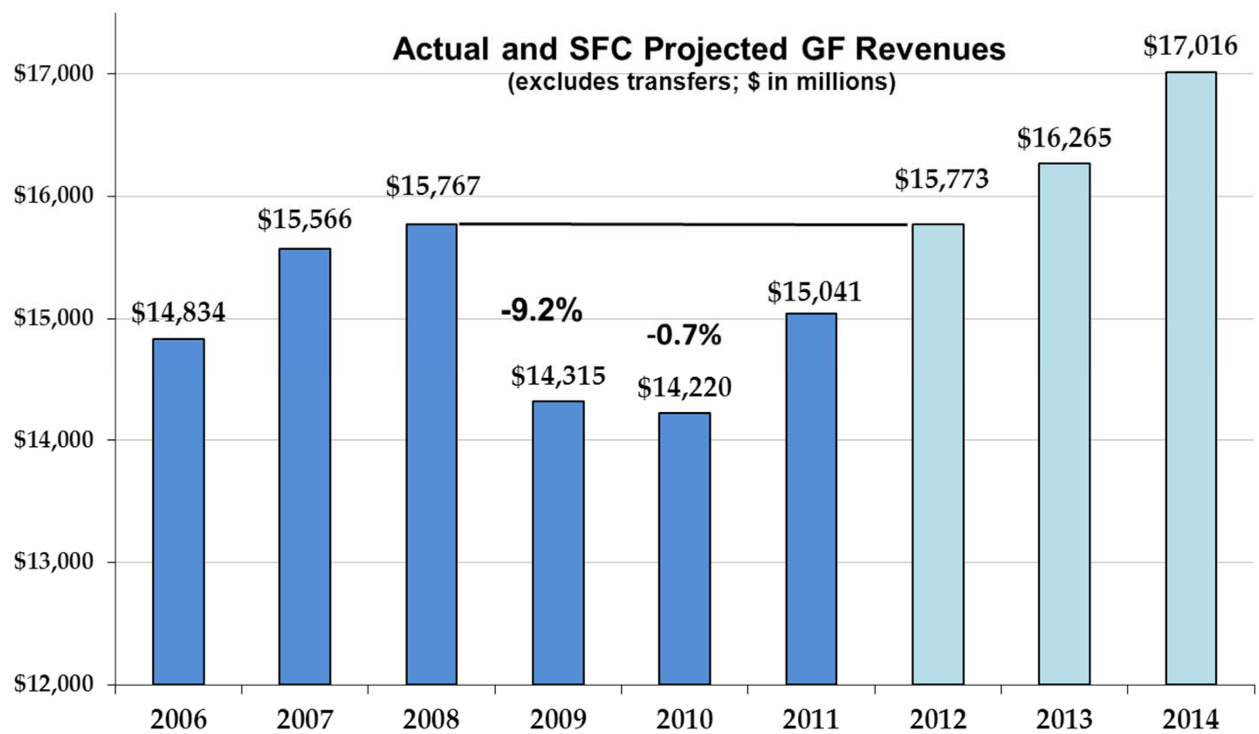
November 17, 2011

2012-14 Biennial Budget Outlook

- Virginia's economic outlook for the next two years continues to be characterized by slow growth and uncertainty.
- Projected revenue growth for the 2012-14 biennium should be sufficient to support the current operating base budget, and replace any one-time revenues or savings that are "propping up" the current FY 2012 budget.
  - Available general fund resources <u>above the base budget</u> total about $1.6 billion.
- Budget pressures from high-priority, mandated programs – Medicaid, K-12 education, and funding pre-deferral VRS rates – will compete for these available resources.
- Balancing this budget will be easier than addressing the last two biennial budgets, but finding new reduction strategies could be challenging.
- Uncertainty about the economy, coupled with potential budget cuts at the federal level, is the backdrop for crafting the 2012-14 budget.

Revenue Performance: A look back and forward

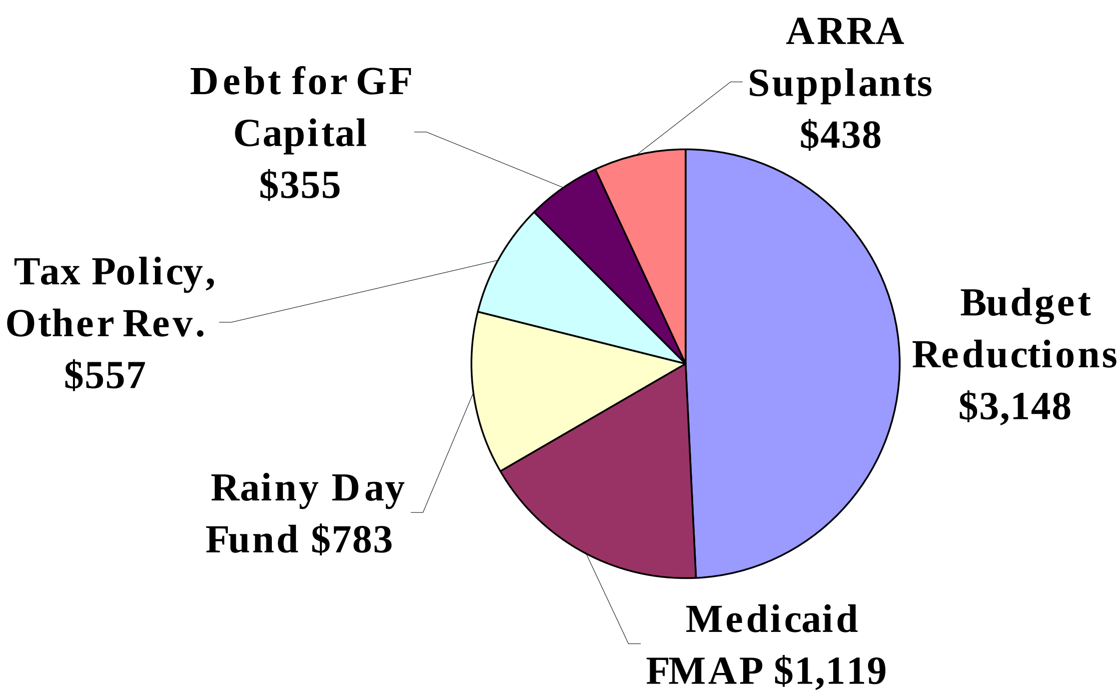
- Two years of negative growth, followed by low growth, made the last two biennial budgets difficult.
  - FY 2011 actual revenues grew by 5.8 percent, but only slightly exceeded the amount collected in FY 2006.
- The current FY 2012 revenue base is roughly equal to that of four years ago.



Closing the budget gap: 2008-10 Biennium

- About one-half of the actions to balance the $6.4 billion in budget shortfalls were one-time in nature.
  - ARRA funds in the 2008-10 budget totaled $2.0 billion.

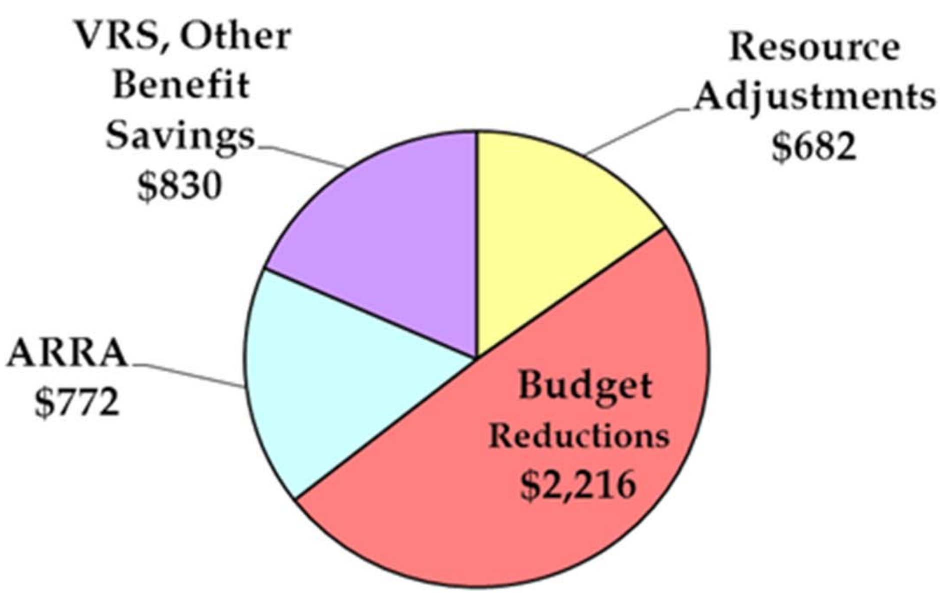
Actions to Close the 2008-10 Budget Shortfalls
$6.4 billion
($ in millions)



Closing the budget gap: 2010-12 Biennium

- Closing the $4.5 billion budget gap relied largely on budget reductions and one-time savings in benefit rates.
  - **K-12 Public Education:** Reductions of $652 million, not including $346 million from reduced contribution rates for VRS and other benefit programs.
  - **Health and Human Resources**: Reductions of more than $1.0 billion, in part to offset growth in Medicaid.
  - **Employee Benefits**: Savings of about $830 million. Deferred approximately $620 million of the VRS retirement contributions.

Actions to Close the 2010-12 Budget Shortfall
2010 Session
($ in millions)



Moving into the 2011 session…

- FY 2010 revenues declined less than expected, resulting in a year-end surplus of $228.5 million.
  - This resulted in revenue adjustments for the 2010-12 budget that totaled about $615.5 million (less than 2 percent of total GF revenues).
- Additional resources were used to partially restore Medicaid cuts and make down payments on required obligations.
  - "Unwinding" of the Accelerated Sales Tax;
  - VRS repayment; and
  - Rainy Day Fund reserve.

2011 Session Major Budget Actions

($ in millions)

	FY 2012
HHR/Medicaid	$173.9
Higher Education – TJ 21 Legislation	97.8
Reduce VRS Deferral Amount	69.8
Increase Rainy Day Fund Reserve	64.0
VITA Costs for Agencies	55.2
K-12 Public Education	48.7
Economic Development Projects	23.6
Phase-Out Acel. Sales Tax (revenue)	45.7
Other Net Actions	36.8
Total	**$615.5**

Developing the next biennial budget: 2012-14

- The biennial **base budget** is the approximate cost of maintaining **current** services and caseloads.

- **One-time** spending items are **deducted** from the FY 2012 appropriation:
  – Rainy Day Fund Reserve of $114.0 million.
  – DOJ Settlement Trust of $30.0 million.

- On-going items that are **not fully funded** in FY 2012 are adjusted and **added** to the base:
  – Replace one-time Medicaid funding shift of $131.6 million from FY 2012 into FY 2011 to gain a higher federal match rate.
  – Annualize partially funded costs, such as local jail reimbursement.

2012-14 GF Base Budget Calculation
($ in millions)

Ch. 890, FY 2012 GF Operating X 2	**$33,096.0**
Minus: One-time Spending	($384.3)
Plus: Technical Adjustments	$281.6
Total, Adjustments to Base	**($102.7)**
SFC Biennial (Two-Year) GF Base	**$32,993.3**

Developing the next biennial budget: 2012-14

- How do projected revenues compare to the cost of continuing the current base budget?
  - Based on SFC staff analysis, revenues for FY 2012-14 should exceed the biennial "base budget" by about **$1.0 billion**.
  - Balances and reserved funds of about $547 million from the 2010-12 biennium roll forward to FY 2013, including:
    - Rainy Day Fund deposit reserves of $246.7 million.
    - Additional revenues of $178.0 million forecast for FY 2012.
- Combined, about $1.6 billion will be available to address mandated or high priority budget pressures.

($ in millions)	**FY 2013**	**FY 2014**	**2012-14**
Revenue Growth Rates	**3.1%**	**4.6%**	
SFC Staff Forecast	$16,265.1	$17,015.7	$33,280.8
Transfers	383.6	391.1	774.7
Total GF Revenues	**$16,648.7**	**$17,406.8**	**$34,055.5**
GF Base Budget	**$16,498.6**	**$16,494.8**	**$32,993.3**
Resources Above Base	**$150.1**	**$912.0**	**$1,062.1**
Plus Balance from FY 12	**547.3**	**0.0**	**547.3**
Resources Available	***$697.4***	***$912.0***	***$1,609.4***

2012-14 Budget Pressures

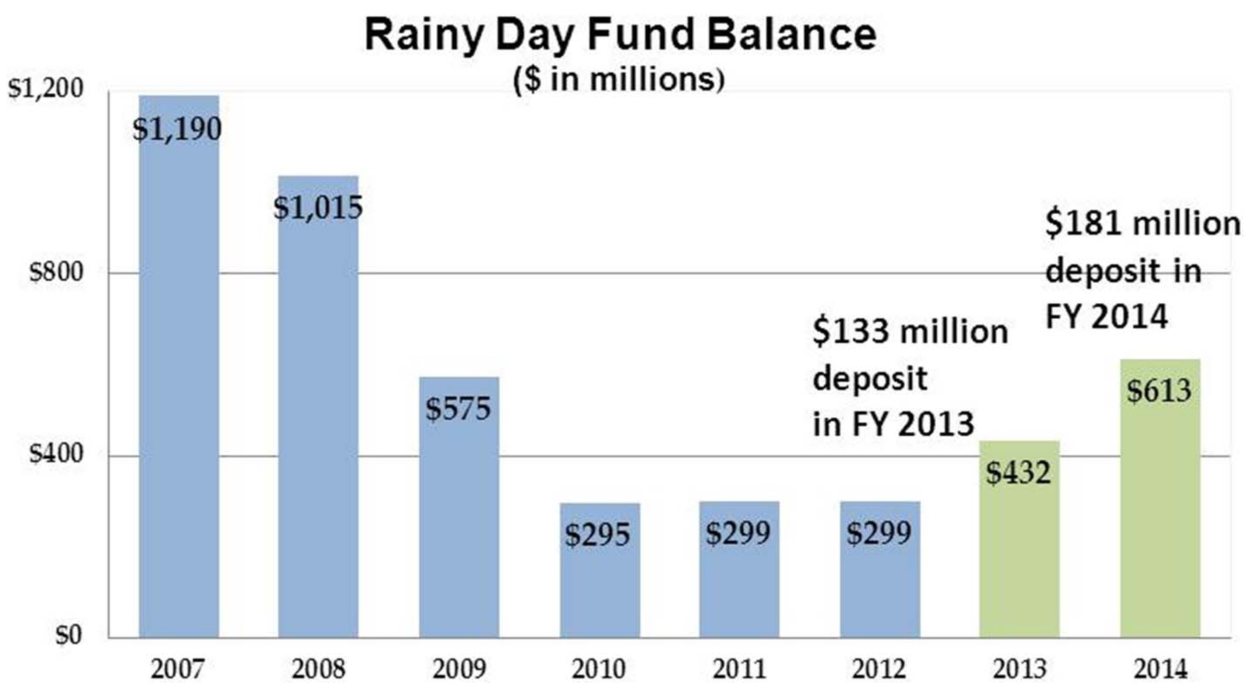
- Budget pressures of more than $2.0 billion will compete for the available $1.6 billion in available resources.
  - Constitutional Rainy Day Fund deposits.
  - Deferred costs that must be recognized in 2012-14.
  - Revised costs of providing services, based on updated data (re-benchmarking or rebasing).

Preliminary 2012-14 GF Budget Pressures
($ in millions)

	FY 2013	FY 2014	2012-14
Rainy Day Fund Deposits	$132.7	$181.0	$313.7
Medicaid Forecast	173.0	477.4	650.4
K-12 Rebenchmarking	175.0	222.2	397.2
VRS – Teachers (range)	148 - 290	148 - 290	296 - 580
VRS – State (range)	117 - 200	120 - 205	237 - 405
DOJ Settlement Costs	30.0	30.0	60.0
Debt Service	25.0	25.0	50.0
DOC – Lost Pa. Revenue	20.4	20.4	40.8
DOC – Inmate Medical	17.2	17.2	34.4
Employee Health Ins.	15.5	15.5	31.0
Child Welfare	8.0	9.0	17.0
Econ. Dev. Commitments	3.8	8.8	12.6
Other (Tech, UI int., SVP)	46.7	27.8	74.5
Total (range)	**$912.2 - $1,137.7**	**$1,302.2 - $1,529.8**	**$2,214.4 - $2,667.5**

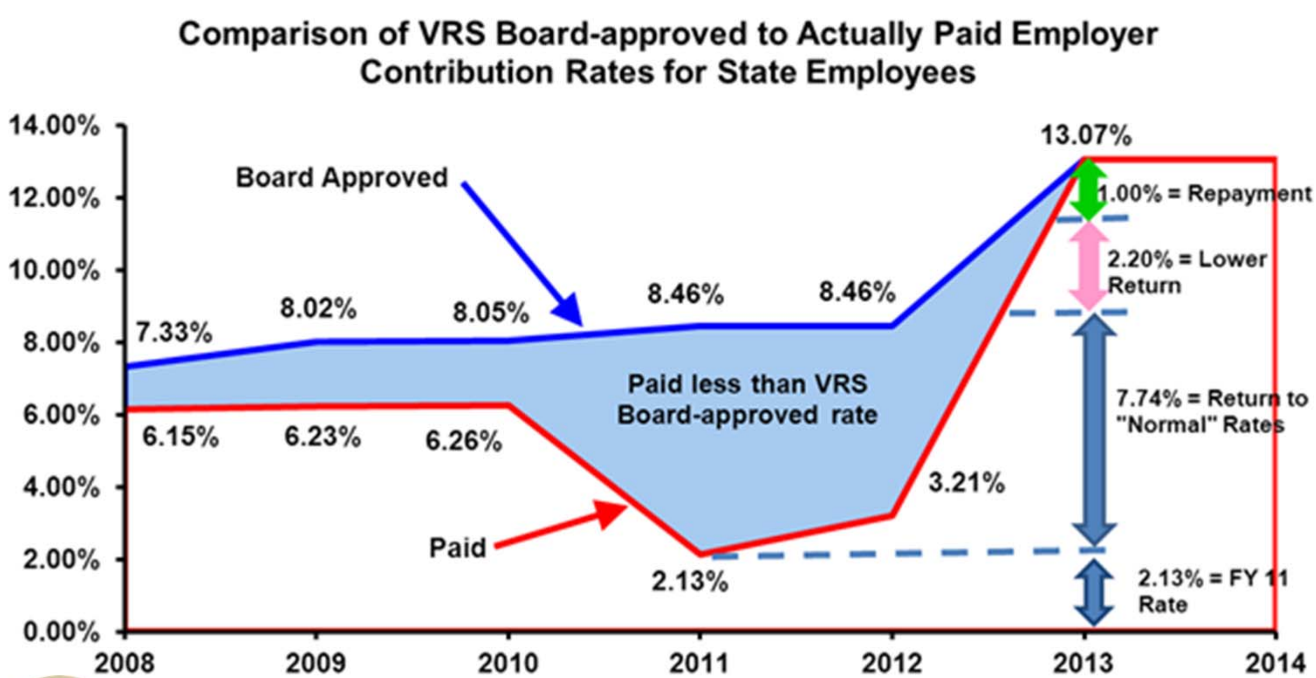
Rainy Day Fund

- Two mandatory deposits to the Rainy Day Fund will be required in the 2012-14 biennium:
  - **FY 2013:** $132.7 million based on FY 2011 actual revenue collections. Amount reserved from surplus at fiscal year-end.
  - **FY 2014:** about $181.0 million based on projected FY 2012 performance. Reserved $114.0 million toward this commitment in the current year.
- Requires about $67 million above amounts currently reserved to cover the two deposits.



Returning to Pre-Deferral VRS Contribution Rates

- Deferring VRS contributions helped balance the 2010-12 budget; rates now return to pre-deferral level.
  - Board-approved rates for next biennium jump because they are making up for two years of paying only PART of the contribution rate typically paid. **State: 13.07%.**
  - Rates include a supplement of about 1% to "repay" over ten years the deferred payments, plus interest.
- The employer contribution rate for state employees would be 9.26% had the board-approved rates been paid over the last twenty years; 12.28% for teachers, rather than 16.77%. (See Tab 10 for more detail.)



Returning to Pre-Deferral VRS Contribution Rates

- State cost to fund VRS rates for the next biennium could range from about $500 million to $1.0 billion, based on various options, including:
  - **VRS Board-Approved Rate:** 30 year amortization, 7% rate of return.
  - **Phase-In:** Use board-approved rate, but phase in over 6 years.
  - **Alternate Rate of Return:** 30 year amortization, 8% rate of return.

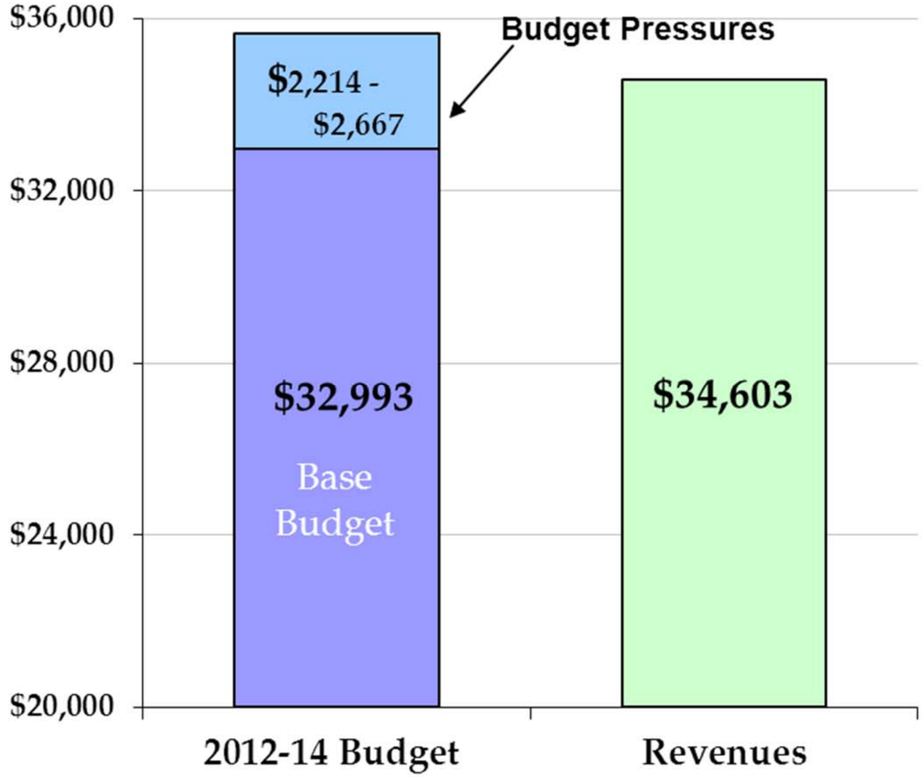
($ in millions)	**FY 2013**	**FY 2014**	**2012-14**
Board-Approved Rate			
State Emp.	$200.7	$205.0	**$405.7**
Teachers	289.7	290.5	**580.3**
Total	$490.4	$495.5	**$986.0**
Phase-In			
State Emp.	$127.4	$130.1	**$257.5**
Teachers	173.5	173.9	**347.4**
Total	$300.8	$304.1	**$604.9**
8% Rate of Return			
State Emp.	$117.0	$119.5	**$236.5**
Teachers	147.9	148.4	**296.3**
Total	$264.9	$267.9	**$532.8**

2012-14 Budget Pressures

- **Medicaid: $173.0 million for FY 2013 and $477.4 million for FY 2014**
  - Additional general fund costs primarily related to medical services utilization and inflation.
  - Medicaid spending trends around 7 percent annually; up to 9 percent in recent years. The expansion of Medicaid due to federal health care reform may push the annual growth rate higher in 2014; federal government will cover most of that share.
  - Savings of $85.4 million in FY 2012 due to lower than expected monthly payment rates to managed care organizations and rebates from prescription drugs.
- **K-12 Public Education Rebenchmarking: $175.0 for FY 2013 and $222.2 million for FY 2014**
  - Partial estimate for rebenchmarking (as of July 28), reflects teacher salaries, health insurance, inflation, and textbooks. Amount includes projected Sales Tax growth (net increase of $44.7 million over the biennium), annual assumed savings from preK slots of as much as $50 million, and $87.7 million for updated Composite Index
  - Other adjustments will include final enrollment projections, funded VRS rates, and Lottery Proceeds forecast.

2012-14 Budget Outlook

- Available resources will fall short of budget pressures.



2012-14 Budget Outlook

($ in millions)

	FY 2013	**FY 2014**	**2012-14**
SFC Forecast	$16,648.7	$17,406.8	$34,055.5
Plus Balances	547.3	0.0	547.3
	$17,196.0	$17,406.8	$34,602.8
Less:			
GF Base Budget	$16,498.6	$16,494.8	$32,993.2
Budget Pressures	912.2 – 1,137.7	1,302.2 – 1,529.8	2,214.4 – 2,667.5
Total (range)	**($214.7 -$440.2)**	**($390.2 -$617.8)**	**($604.9-$1,058.0)**

2012-14 Budget Pressures

- Other potential high-priority spending items not included in the Budget Pressures include:
  - **Higher Education** – Funding to implement "Top Jobs" legislation, including address enrollment growth, promote STEM degree production, financial aid, maintenance of new facilities.
  - **Salary Increase** – 1 percent increase for state employee groups (including faculty and state-supported locals) = $37.0 million per year. Last increase Nov. 2007; 3% bonus in 2010.
  - **Teacher Salary Increase** – 1 percent increase = $36.5 million; last state-funded increase Nov. 2007.
  - **DEQ Point Source Fund** – $104 million to address shortfall in the fund for existing projects with signed agreements, plus funding for projects due next biennium; could fund with debt.
  - **Maintenance Reserve** – Funding of roughly $50 million per year has been provided in recent years; could fund with debt.
  - **Equipment for New Facilities Coming on Line** – About $40 million; could fund with debt.
  - **Fort Monroe Authority** – Operating costs, replace lost federal funds = $5 to $6 million per year.
  - **HB 599** – Minimum to level fund at FY 2011 level = $6 million per year.

Budget Balancing Options

- Depending on choices made, the budget gap could range from about $600 million to $1.0 billion – easier task to resolve than in recent years. Options include:

- Targeted or across-the-board general fund reductions.

  - Governor asked agencies to develop 2%/4%/6% budget reduction plans. Medicaid and public education were exempt from this exercise, but may receive "targeted" reductions.
  - Institutions of higher education were exempted but recommended a reallocation of 2% of general funds to fund TJ 21 initiatives.

2%	**$ 73 million per year**
4%	**$146 million**
6%	**$220 million**

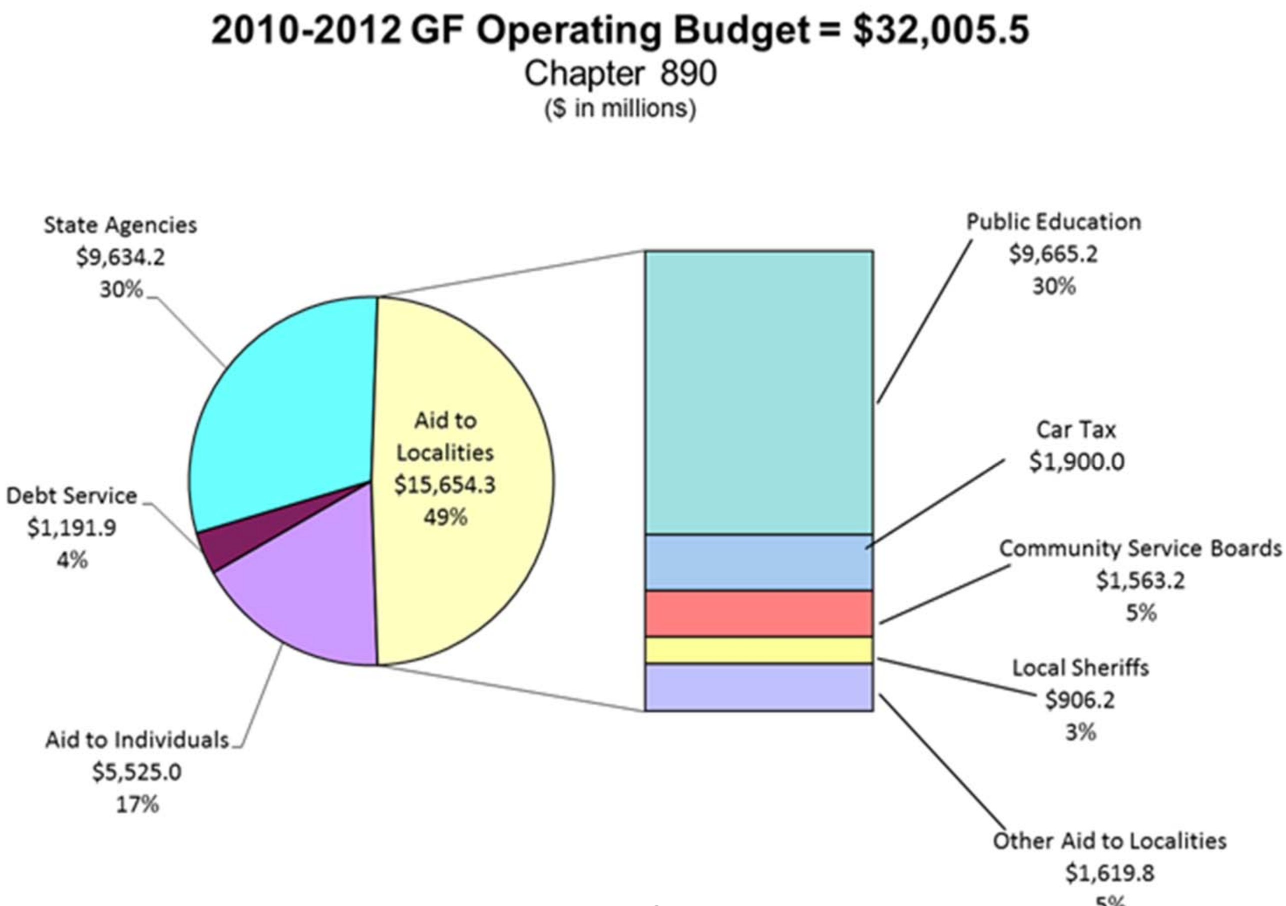
- Reduce state cost of mandated or high-priority spending items.

  - Redefine costs through changes to funding methodology.

- Increase revenues, reduce tax preferences, or cost-shift to user fees.

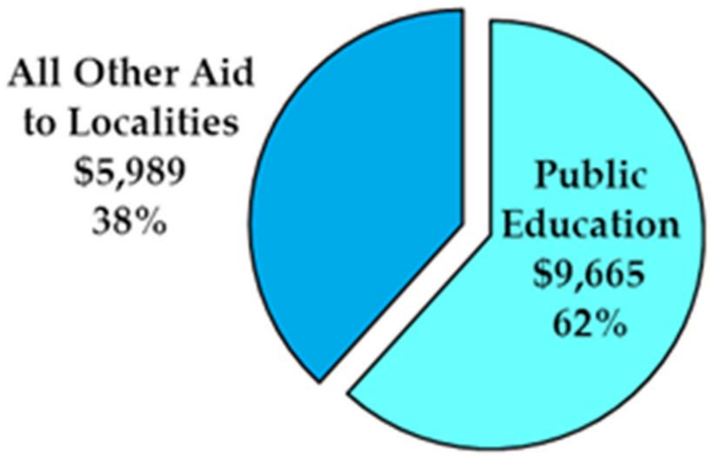
General Fund Budget Drivers: where does the money go?

- Aid to localities remains the largest component of the general fund budget.
  - Slightly less than **one-half** of the general fund budget goes to support several large state programs delivered at the local level, and local tax relief (down from 51% in 2010).

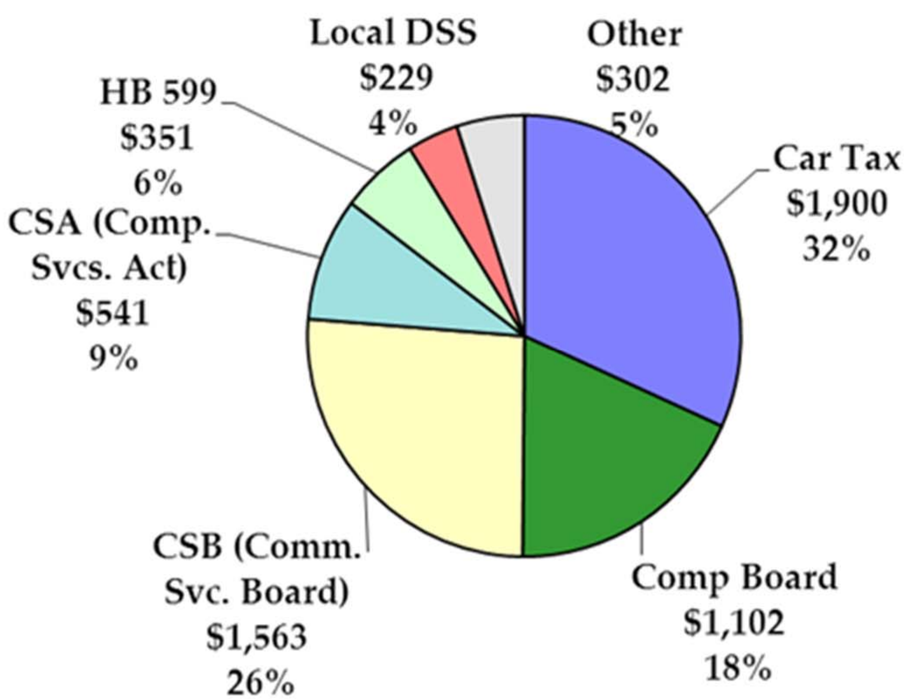


"State Agencies" includes institutions of higher education, corrections, natural resources, judicial, legislative, executive, and administrative agencies.

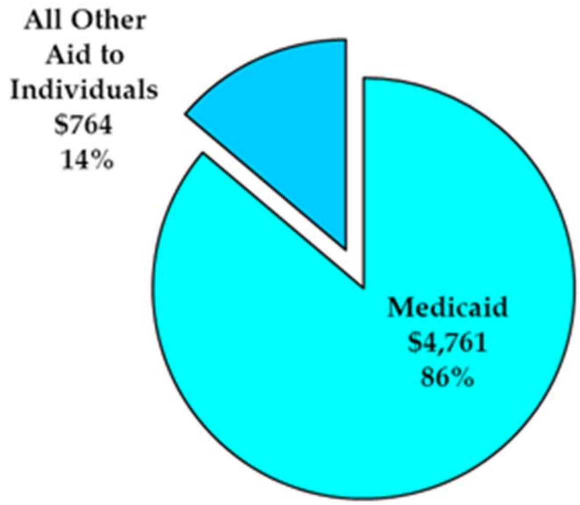
Aid to Localities
2010-12 = $15.7 billion

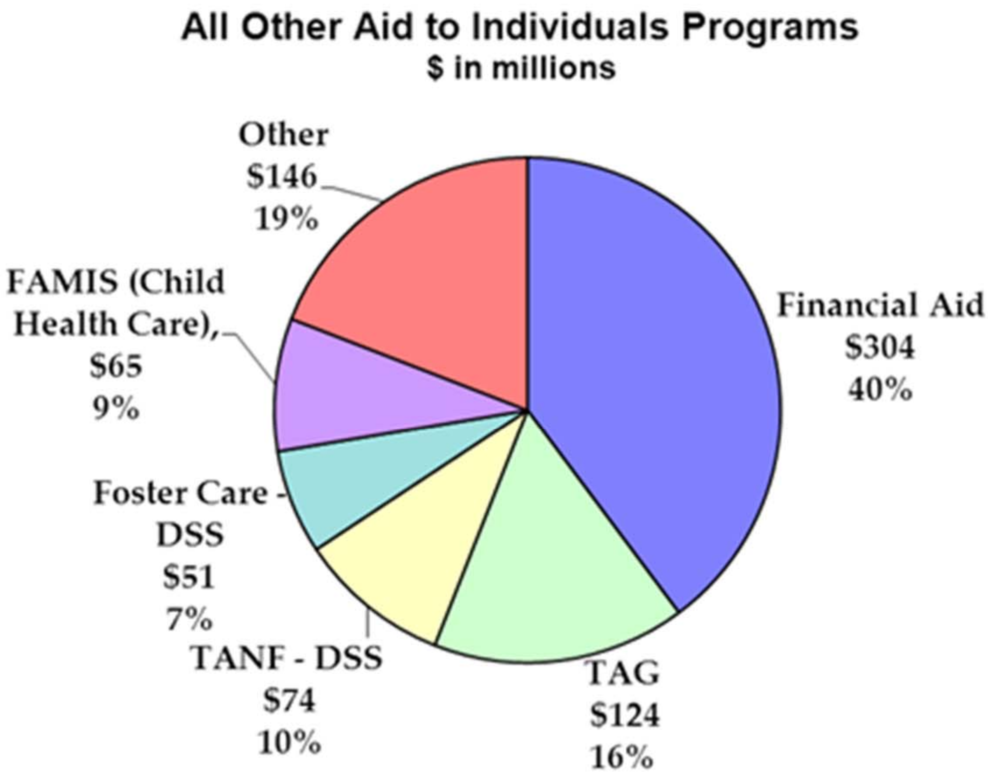


All Other Aid to Localities Programs
($ in millions)



Aid to Individuals
2010-12 = $5.5 billion

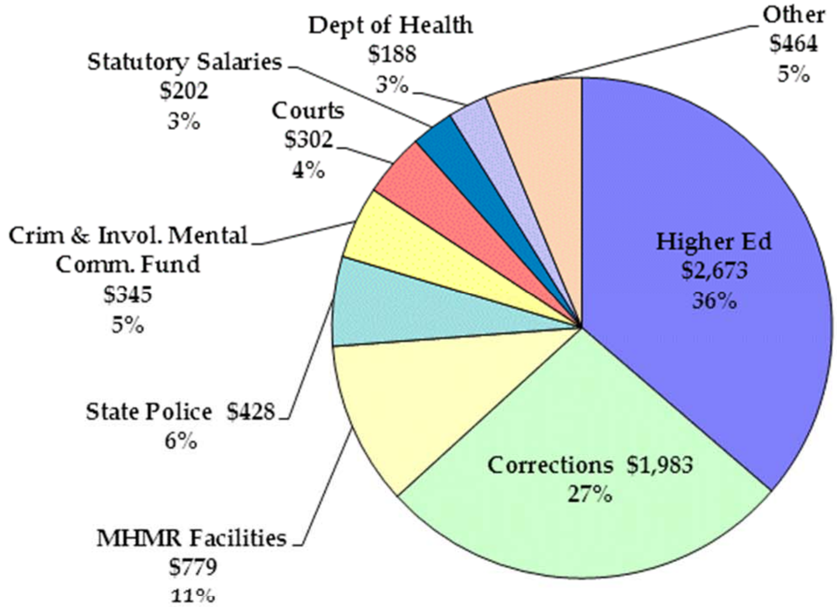




Other State Programs 2010-12 = $9.7 billion

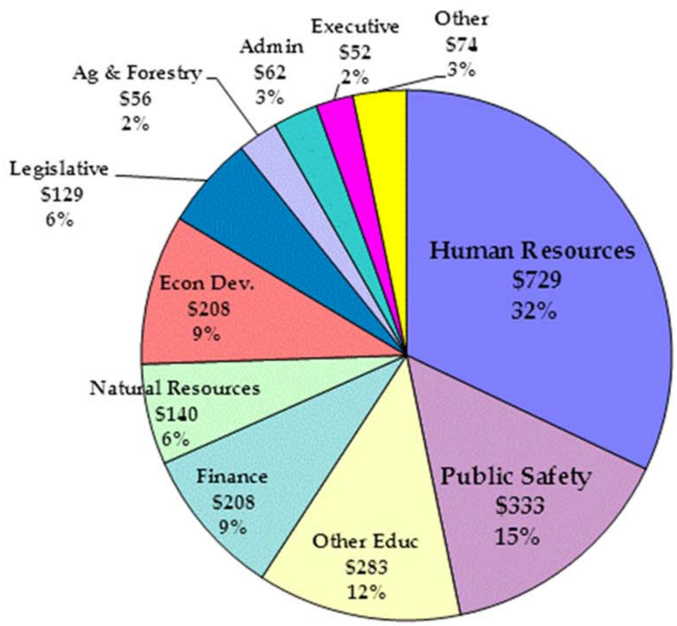
Major State Programs & Systems = $7.4 billion

($ in millions)



All Other Programs = $2.3 billion

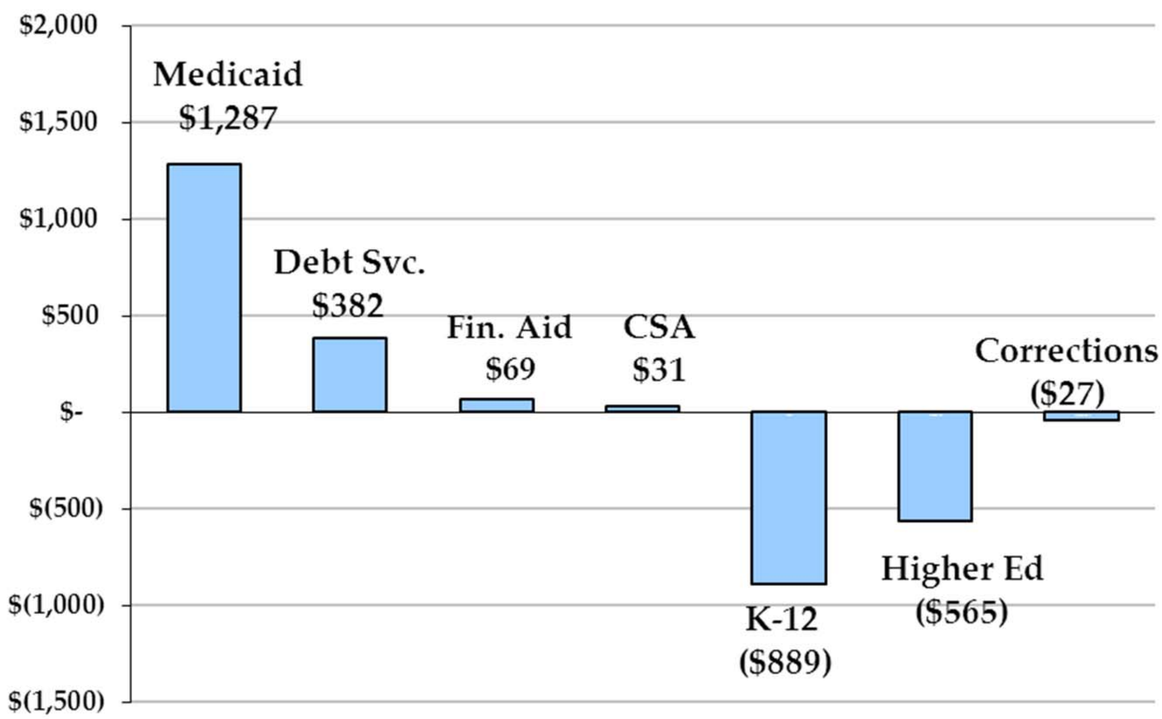
($ in millions)



Budget changes have varied across programs, agencies

- Compared to 2006-08 budgets (pre-recession), some programs have seen increases in general fund spending, while others have been reduced to cover budget shortfalls.
  - Medicaid, Debt Service, Financial Aid, and Comprehensive Services Act are among those programs that have grown during this period.

2006-08 Biennial Budget Compared to 2010-12 Biennial Budget (GF $ in millions)



Three fundamental questions guide budget balancing decisions

1) What services should the state provide?

- Reduce the scope of services provided.
- Redefine standards or guidelines that drive funding.
- Eliminate programs or services that are not mandated.
- Re-organize or consolidate agencies; find efficiencies.

2) Who receives the services?

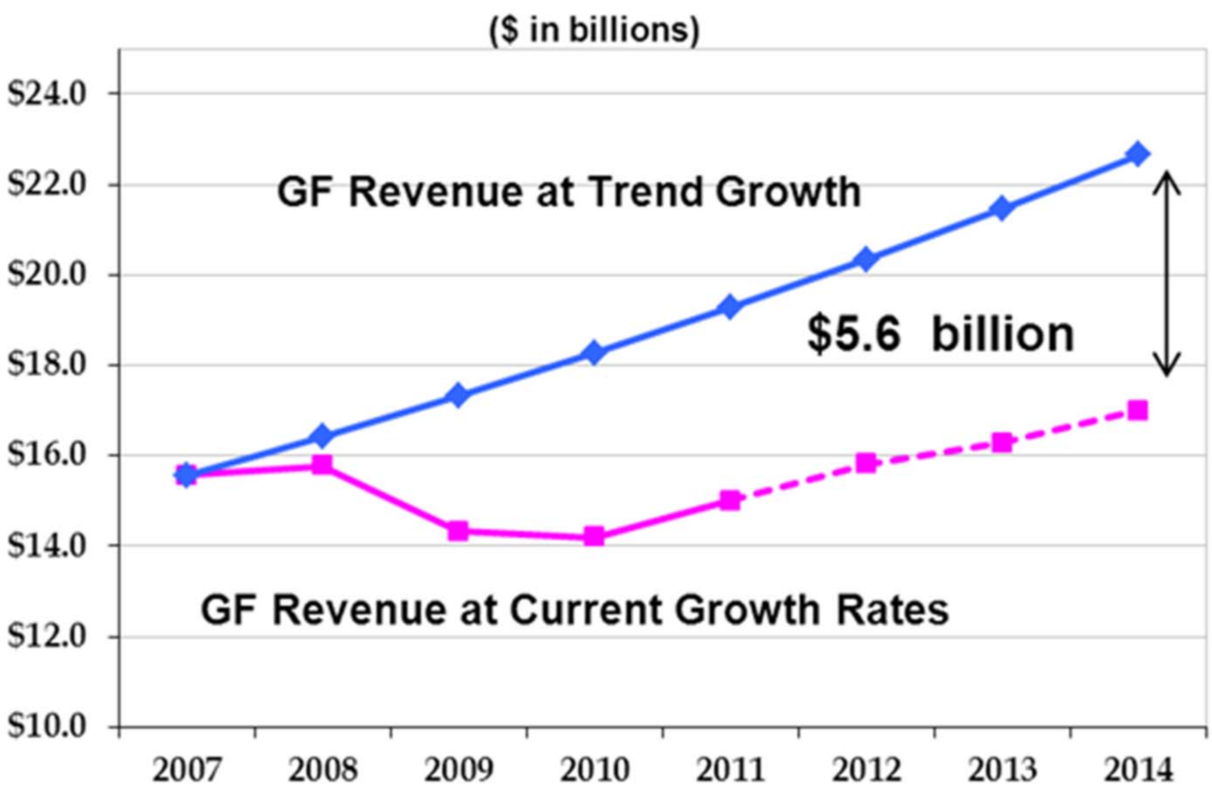
- Change eligibility criteria for who qualifies to receive the services.

3) Who pays?

- Shift costs to other payers: localities, increase fees for services, raise tuition, reduce reimbursements to providers.
- Find opportunities for consolidation or regionalization of state services.
- Provide more flexibility for local entities that deliver state programs.

Looking ahead to the next biennium

- Virginia has seen five years of negative or below-trend revenue growth.
- Even if revenue growth returns to historical levels of about 5.5 to 6.0% per year, the revenue base has been lowered.
- Expected growth rates of 3.1% in FY 2013 and 4.6% in FY 2014 lag historical growth rates.



Challenges of the 2012 Session

- Uncertainty surrounds the national economic outlook and the revenue forecast for Virginia for the remainder of FY 2012 and the next two fiscal years.

- Projected revenue growth covers the cost of the current services biennial budget.
  - About $1.6 billion should be available to address **most** mandated, high priority budget pressures.
  - Budget pressures – primarily Medicaid, K-12 rebenchmarking, and returning to pre-deferral VRS rates – could range from $2.2 to $2.7 billion.

- Funding the base budget and known budget pressures could exceed available resources by $600 million to $1.0 billion.

- Biggest unknown – federal deficit reduction actions.
  - Direct impact on state programs.
  - Direct/indirect impact on Virginia's economy.

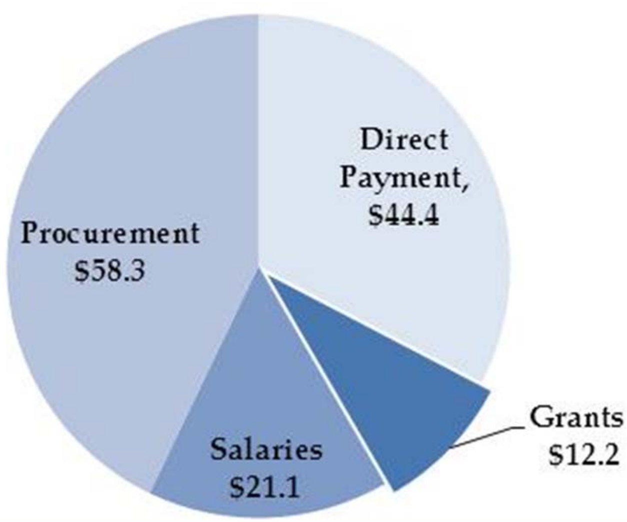
Federal Budget Debate – what does it mean for Virginia?

- What might Virginia expect?
  - Direct reductions to defense expenditures, federal employees.
  - Direct reductions to R&D spending, federal procurement.
  - Direct reductions to grants, including Medicaid.

- Bond rating agencies concerned about Virginia's dependence on federal funds.
  - Moody's assigned Virginia a "negative outlook", along with several other states with a large federal spending presence.

FY 2010 Federal Expenditure Data - Virginia

$ in billions



Federal Budget Debate – what does it mean for Virginia?

- What are we hearing about the Joint Select "Super Committee"?
  - "Something short of failure."
  - "Sequestration will be undone."
  - "Compromise talks remain alive though troubled."

- Timing couldn't be worse - too late for the Governor to incorporate impact into his budget
  - JSC won't act until November 23, 2011.
  - Congress votes up or down on a proposal (if one is produced) by December 23, 2011.

- GA may be forced to deal with impact during 2012 Session.
  - Governor proposed to set aside $30 million of surplus for Federal Action Contingency Fund.

- If sequestration trigger is pulled, would take effect January 2013 – 6 months into the budget adopted next session.
  - But, Congress could repeal the Budget Control Act…

Impact on State Programs

- Fiscal impact on state programs and agencies difficult to determine. Recent survey to assess impact of 8.8% reduction if sequestration occurs.
- **Medicaid:** A 1 percent reduction in Medicaid spending translates into a $36 million GF impact.
- **Public Education:** Federal funds statewide are about 7 percent usually, but varies by school division. Two largest programs are Special Education at about $300 million; Title I funding totals about $250 million per year.
- **Public Safety:** Emergency Management receives $35 million per year for homeland security grants and emergency planning and training, and support of the emergency operations center.
- **Natural Resources:** EPA Clean Water State Revolving Fund grant of $30.5 million and EPA Drinking Water State Revolving Fund grant of $15.9 million (2010 figures).

Impact on State Programs

- **Higher Education:**
  - **UVA**: A reduction of 8.8% in federal grants and contracts would amount to approximately $29.6 million, or the equivalent of 115 FTE positions.
  - **VCCS:** A reduction in federal financial aid grants at 8.8% could result in a decline in student headcount as well as overall credit hours taken. It is possible that the decline could be as much as 3-5%, although specific projections are difficult to estimate.

	Federal Grants/ Contracts	8.8%	Student Loans, Work Study, Pell Grants	8.8%
UVA	$336.8	$29.6	$161.4	$14.2
Va Tech	212.9	18.7	146.3	12.9
VCU	161.3	14.2	273.2	24.0
GMU	86.0	7.6	181.0	15.9
CWN	18.3	1.6	50.1	4.4
VCCS	45.0	4.0	487.8	42.9

In conclusion

- Slow growth, caution, uncertainty – watchwords for the next session as you develop the biennial budget.
- Funding the base budget and known budget pressures could exceed available resources by $600 million to $1.0 billion.
- Federal deficit reduction actions loom large. How should Virginia position itself to respond?