2013 Session
Budget Outlook

November 14, 2012

2013 Session: What can we expect?

- Virginia's economic outlook for the remainder of the current biennium continues to be characterized by slow growth and uncertainty.

- Projected resources for the remainder of the biennium should cover most of the high priority budget items.
  - Available general fund resources above the adopted budget total about $339 million, including $212 million in revenue and transfer adjustments.
  - Budget pressures from high-priority, mandated programs – such as Medicaid (net of rebates) and employee health insurance -- total about $164 million.

- Uncertainty about the economy, coupled with potential budget cuts at the federal level, calls for a continued cautious budget approach.

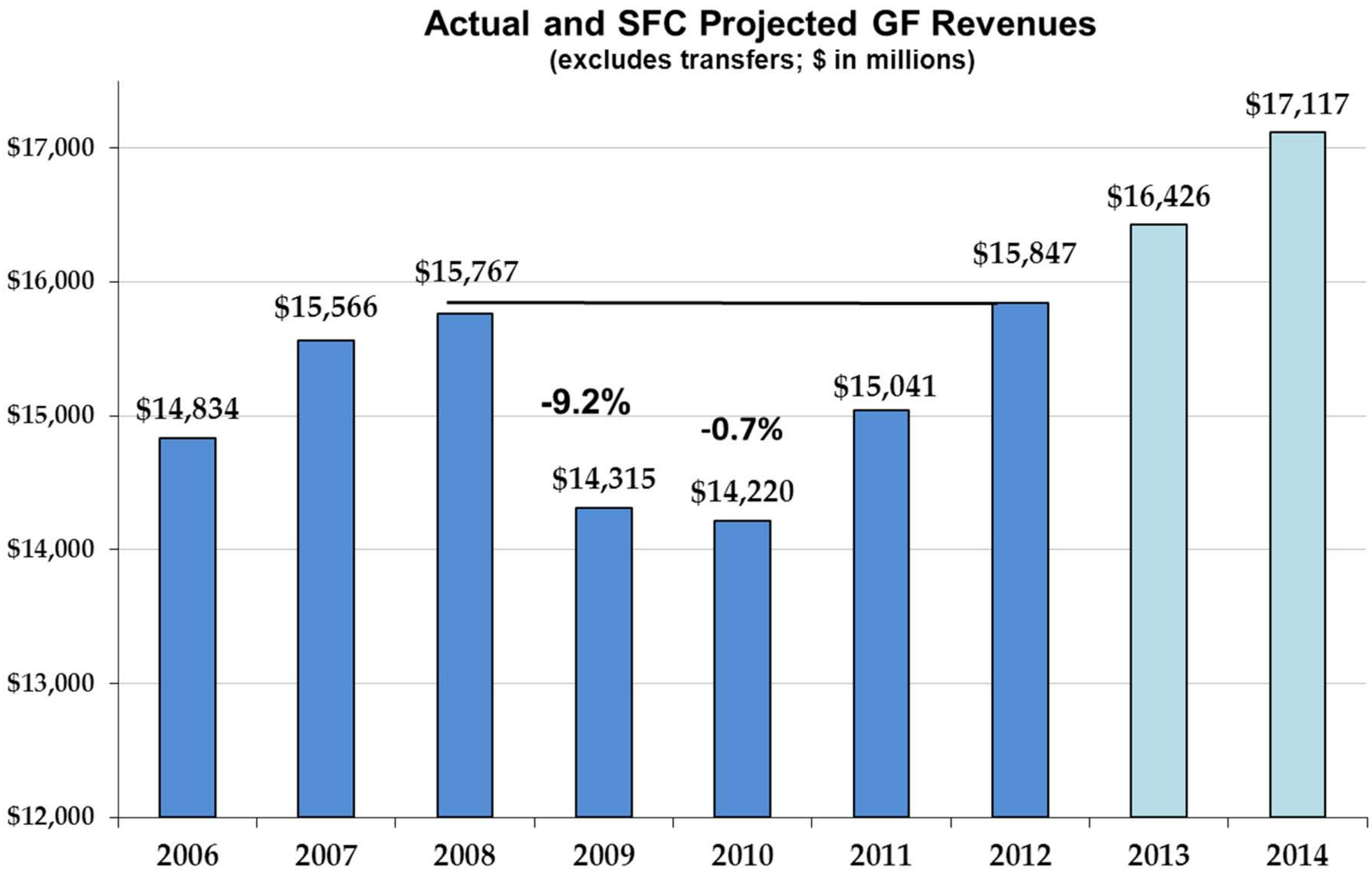
Indicators of a more stable budget

Where are we, three years out from the end of the Great Recession?

- Positive revenue performance – back to 2008 levels.
- Rebuilding cash balances – important to rating agencies.
- Addressing unfunded liabilities.
- Funding employee salaries.
- Addressing growth in high-cost programs.

Much of this progress was made in the 2012 Session.

Revenue Performance:
GF revenues return to 2008 level

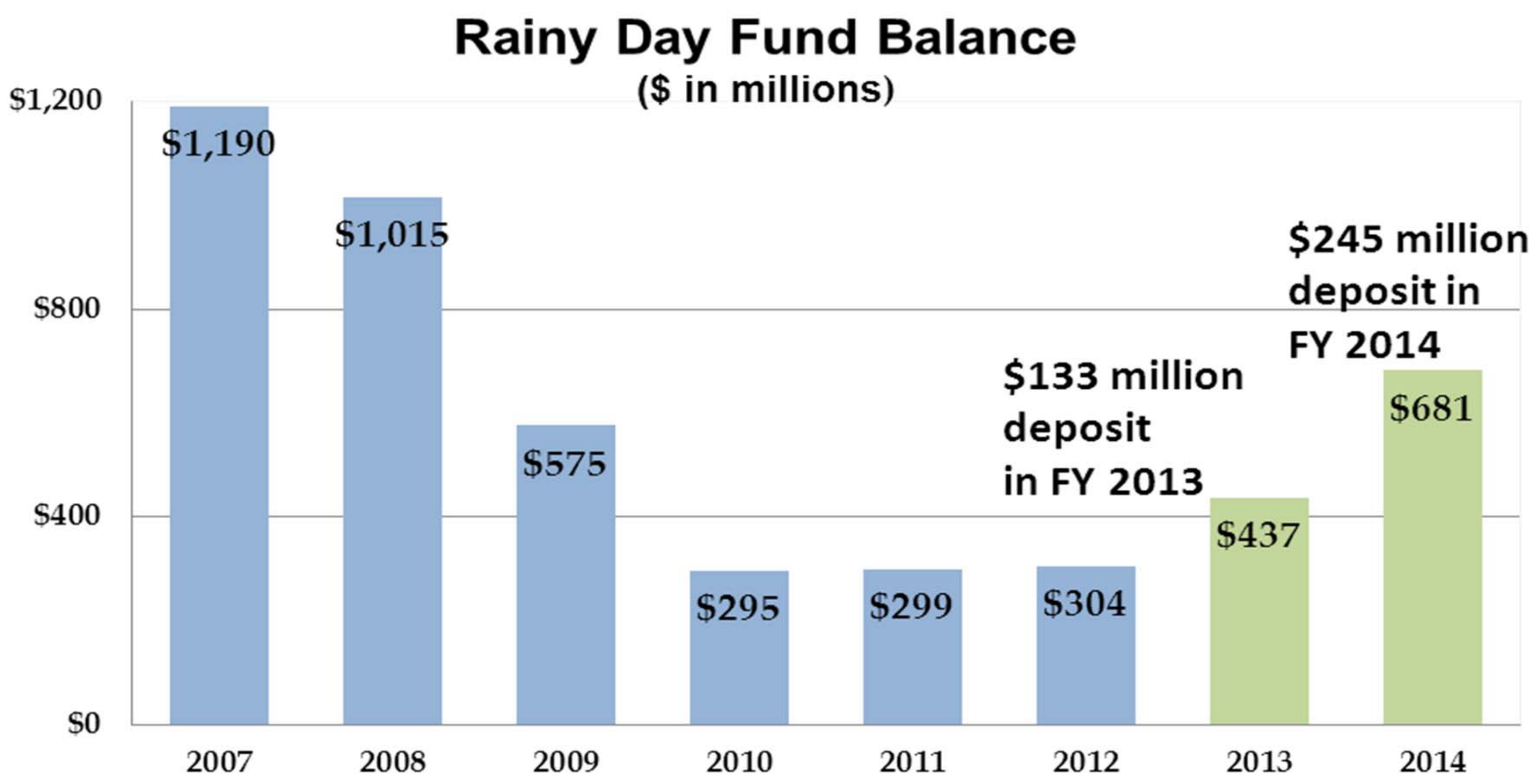


Recap of the 2012 Session: Objectives of the adopted budget

- Set aside more funding for the Rainy Day Fund; create "FACT" fund reserve.
- Improve structural balance in the budget.
- Address the funding of the VRS.
- Selective spending:
  - Invest in education.
  - Protect the health care "safety net".
  - Stimulate job creation.
  - Address employee compensation.
- Reduce the burden on Virginia's businesses.

Rebuilding the Rainy Day Fund

Two deposits bring the fund to its highest balance since 2008.



Created $30 million FACT Fund

- **Established the Federal Action Contingency Trust (FACT) fund as a "cushion" against potential cuts in federal spending.**

- Legislative commission established to advise Governor on uses, including:
  - Assist localities with BRAC-related projects;
  - Continue statutorily required, federally mandated programs if reductions are imposed; and
  - Fund economic development activities to assist businesses affected by federal budget reductions or BRAC decisions.

- Capitalized with $30 million from FY 2011 balances. Budget language authorizes an additional $20 million deposit, contingent upon FY 2013 balances.
  - $7.5 million earmarked for airspace encroachment in Virginia Beach.
  - If sequestration does not take place, $2.0 million can be used to address airspace encroachment at Langley, and $4.0 million for other economic development projects.

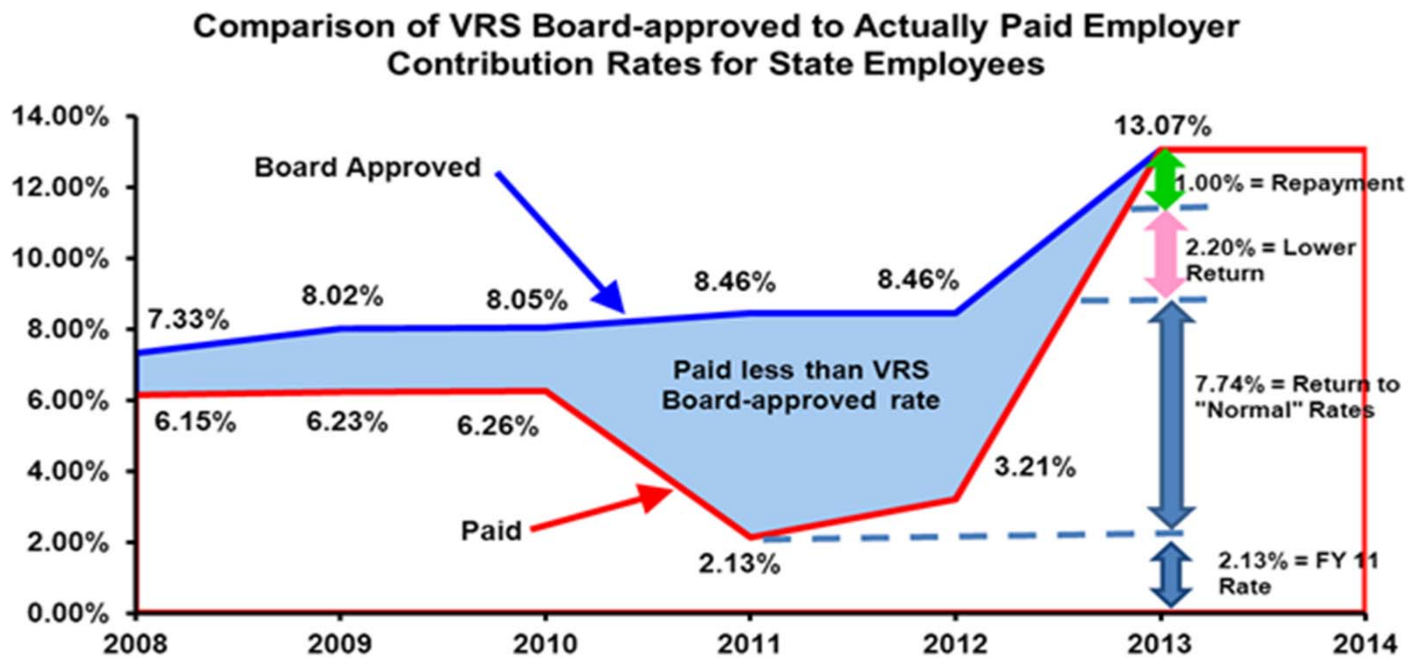
Improving “Structural Balance”

- **Continued to unwind one-time savings and revenue sources -- “budget gimmicks”.**
- Reduced the Accelerated Sales Tax by $50.0 million in FY 2012 – ahead of schedule.
  - About 96% of retail merchants are no longer transmitting sales tax early.
- Aid to Localities Reversion – reduced from $60 million to $50 million in FY 2013; down to $45 million in FY 2014.
- Fully-funded items in the second year (mostly).
- Matched one-time resources with one-time expenditures.

Improving “Structural Balance” – VRS

Unwinding one-time savings from 2010

- **Provided $342.4 million for teachers and $86.2 million for state employees to fund higher VRS costs in this biennium (another $260 million for state employees was covered in the revenue adjustments).**
- Rates jumped dramatically to make up for two years of paying only <u>part</u> of the contribution rate typically paid.



Addressed Unfunded Liabilities

- **Stabilized and strengthened the Virginia Retirement System.**

Pension Reform	
2010	• "Plan 2" status created for new employees (age, Avg. Final Comp., COLA)
2011	• State employees to pay 5 percent employee share (offsetting increase) • Updated JLARC study
2012	• **Hybrid combination Defined Benefit-Defined Contribution plan created for new employees** • **Phase-in over six years to full-funding of the actuarial recommended contribution rates** • **Plan 1 changes for non-vested employees** • **Local and school employees to pay the 5 percent employee share**

- Moody's Investor Service issued a notice citing Virginia's pension reforms as a "credit positive."

Other Investments

- Higher Education – additional funding of over $200 million for the biennium. Lowest annual tuition increases in a decade.

- Funded $87.6 million to meet the state's share of the costs for signed grant agreements for upgrading wastewater treatment plants.
  - $45.3 million for WQIF deposit from surplus, plus $42.3 million from GF cash.

- Returned to funding employee compensation.
  - Funded a 3 percent employee bonus from FY 2012 surplus and balances.
  - Full-year funding for a 2 percent salary increase in July, 2013 for classified employees, faculty and state-supported locals.

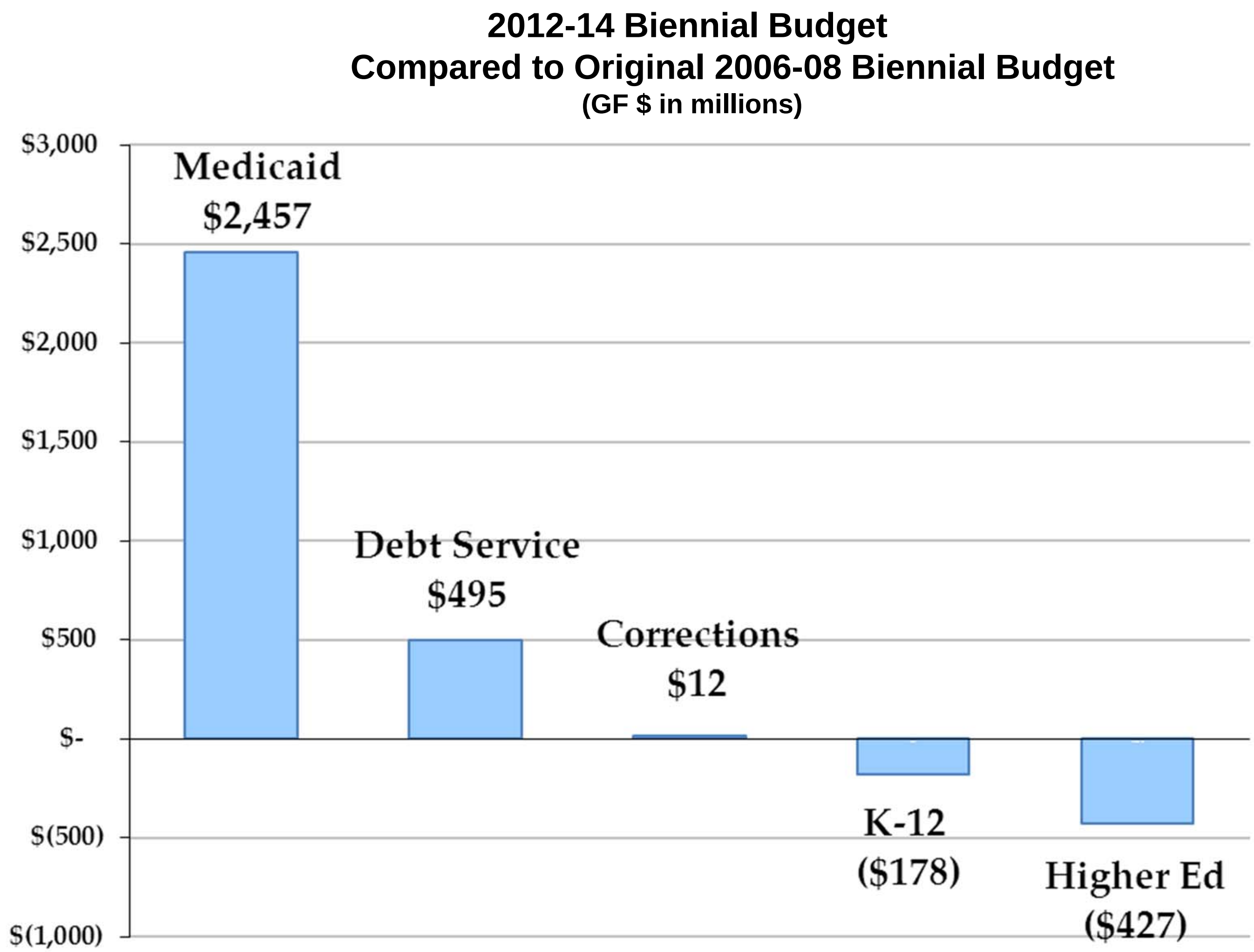
- Directed $65.9 million in one-time general funds from mortgage settlement; used for one-time purposes.
  - $7.0 million to capitalize a Housing Trust Fund; allocated the balance of $58.9 million toward K-12 Public Education in one-time funding that can be used for retirement, inflation, and pre-K programs.

Balancing the budget required spending cuts

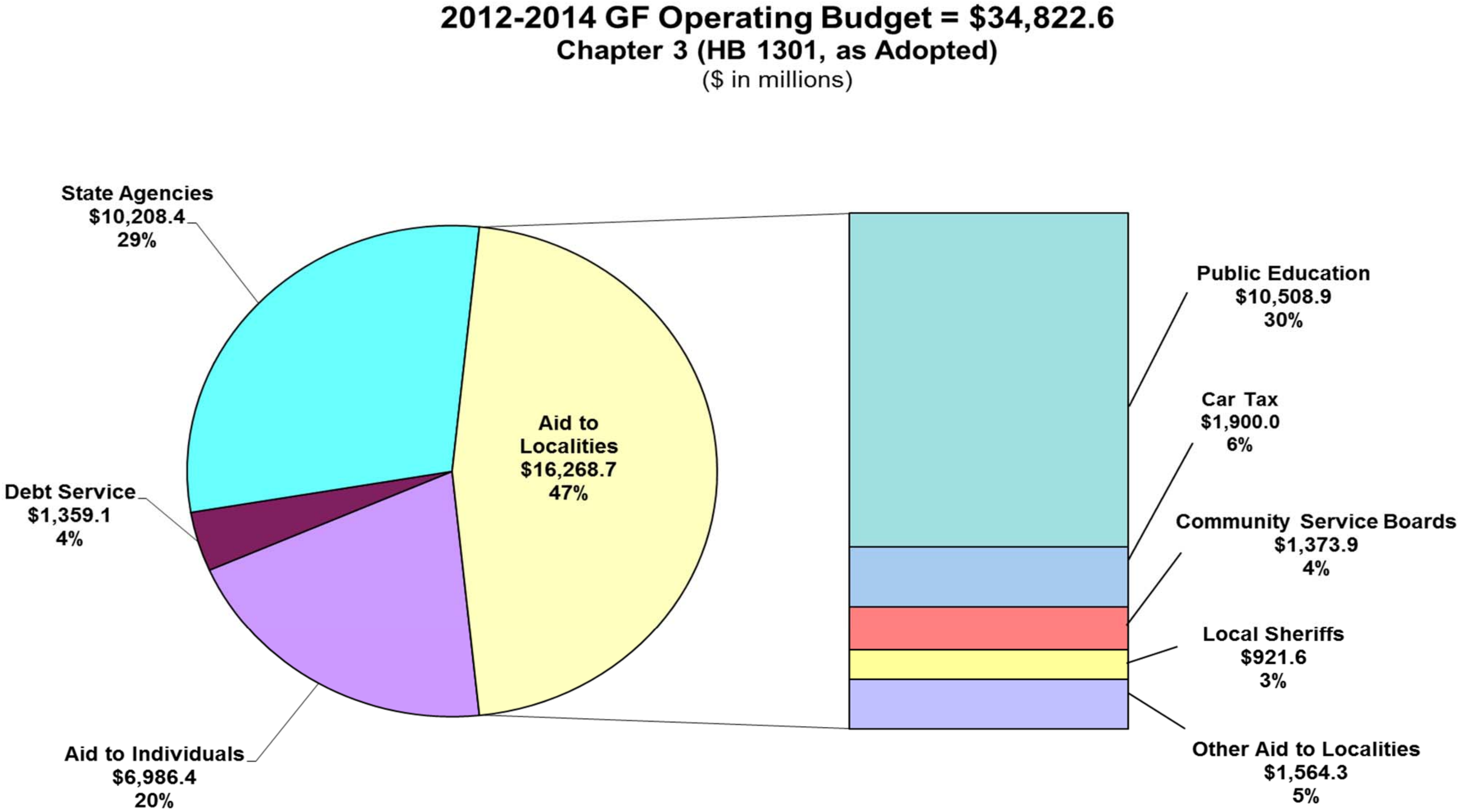
- To increase fund balances, address VRS, improve structural balance and to cover growth in high cost programs required actions to achieve savings in Medicaid and K-12 public education funding.
  - Additional **available resources** of about **$2.3 billion** above the "base budget", to address **$3.3 billion** in **spending** for retirement rates, Medicaid, public and higher education.
  - Offset by **$1.1 billion** in **targeted reductions** in Medicaid, K-12 education, and agency-specific savings.

2012-14 GF, $ in millions		
	Medicaid	**K-12**
Spending	$666.7	$971.7
Savings	(417.0)	(366.4)
Net	$249.7	$605.3

Budget changes have varied across programs, agencies



General Fund Budget Drivers:
Percent of budget to locals has declined



High priority spending items for next session

2012-14 GF Spending/Savings Items

($ in millions)

	FY 2013	FY 2014	2012-14
Medicaid Forecast Adjustment	$ 46.0	$ 69.0	$115.0
Health Care Fund Rebates	(130.3)	(65.0)	(195.3)
Correct 2nd Year UVAH/VCUHS	0.0	11.5	11.5
DBHDS Early Intervention Services	4.0	10.5	14.5
DOJ Settlement Implementation	0.0	6.8	6.8
K-12 Sales Tax Adjustment	8.2	15.3	23.5
K-12 Technical Adjustments	1.1	5.4	6.5
Public Safety (inmate medical)	0.0	20.6	20.6
Comp Board (per diems, new jails)	6.3	5.0	11.3
Judicial (criminal fund)	1.3	2.8	4.1
Employee Health Insurance	0.0	50.0	50.0
Water Quality A&B (from surplus)	0.0	16.9	16.9
Required Rainy Day Fund Deposit	0.0	78.3	78.3
Preliminary Total	**($63.4)**	**$227.1**	**$163.7**

Projected Medicaid spending continues to slow

- **Additional funding of $115 million for the biennium.**
  - Pharmacy rebates paid by Medicaid managed care organizations as required by the Affordable Care Act (ACA) result in net savings of $80.3 million for the biennium.

GF $ in millions			
	FY 2013	**FY 2014**	**2012-14**
Adjustment to Forecast	$ 46.0	$ 69.0	$115.0
FY 12 Rebate Balances	(65.3)	0.0	(65.3)
Pharmacy Rebates	(65.0)	(65.0)	(130.0)
Total	**($84.3)**	**$ 4.0**	**($80.3)**

- **Decisions on two major policy issues – health exchange benefits and expansion of Medicaid coverage – will dominate the discussion in this area.**

State Employee Health Insurance: Another bill in the drawer

- **About $50 million GF required in FY 2014, pending final actuarial calculations.**
  - Increased cost can be shared between employer/employee.
- Since FY 2009, the premium that employers and employees *should* pay has been subsidized by balances from the Health Insurance Fund (HIF).
  - The HIF could go negative as early as April, 2013.
- The 2012 budget, as introduced, included several health insurance savings features that were not adopted by the GA.
  - As a result, the rate paid is about 10% below what it should be. Draws against the HIF are again covering the difference.
- Other factors affecting the rate include higher claims in 2012, impact of the Affordable Care Act, and a slightly higher expected trend for FY 2013.
- Estimate above does NOT include funding needed to rebuild the HIF to maintain adequate reserves for costs incurred but not yet reimbursed.

Budget Outlook 2013 Session

- Available resources will likely cover the high priority budget pressures, leaving some room for other items.
  - Potential impact on the 2014-16 biennial budget -- may want to consider directing available resources to one-time uses, rather than building a larger base budget.

2012-14 Budget Outlook

($ in millions)

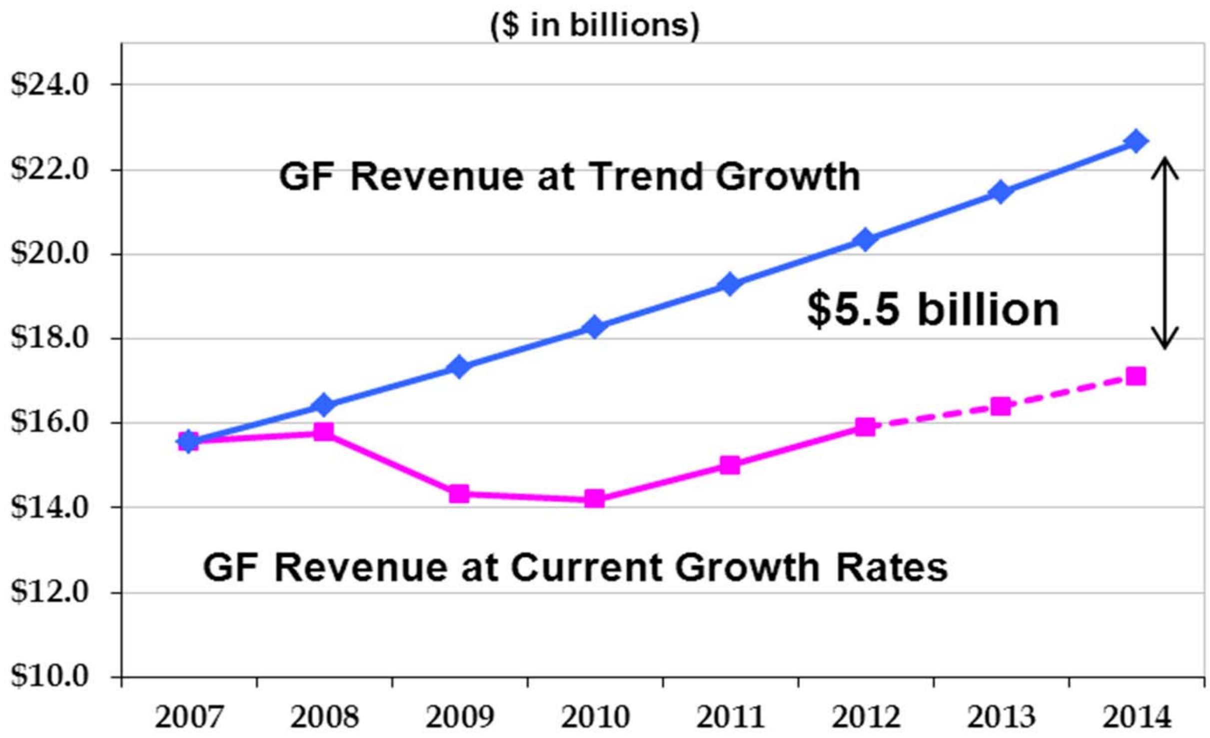
	FY 2013	**FY 2014**	**2012-14**
Chapter 3, 2012 GF Revenues	$17,389.3	$17,459.9	$34,849.2
Revenue Adjustment	$123.6	$88.8	$ 212.4
Balances, Other	115.2	11.3	126.5
Total, Additional Resources	**$238.8**	**$100.1**	**$338.9**
Budget Pressures	($ 63.4)	$227.1	$163.7
Net Available	**$302.2**	**($127.0)**	**$175.2**

Other potential high-priority spending items

- **DEQ Point Source Fund** – Additional $28.3 million to $44.0 million to fund water quality improvement projects. Includes $5.0 million for CSOs; could fund with debt.
- **Aid to Localities Reversion -** $45 million remains in FY 2014.
- **Teacher Salary Increase** – 1 percent increase = $36.7 million; last state-funded increase Nov. 2007 (*K-12 not included in 2012 Session bonus or salary actions*).
- **K-12 Public Ed** – $18 million in FY 2014 for Cost of Competing (COCA).
- **Higher Education** – $27 million to maintain the current level of financial aid support.
- **Equipment for New Facilities Coming on Line** – About $15 million; could fund with debt.
- **Capital Outlay Projects** – Lots of projects in the pipeline (between $750 million and $1.0 billion authorized for detailed planning).

Below trend revenue growth rates continue

Virginia has seen five years of negative or below-trend growth. Rates of 3.5% in FY 2013 and 4.1% in FY 2014 continue to lag historical growth rates.



"Fiscal Cliff" What does it mean for Virginia?

- At the end of calendar year 2012 and the beginning of 2013, several major fiscal events are set to occur all at once, including the expiration of major tax cuts and the implementation of **sequestration**:

  > *"..those random cuts that got scheduled when Congress voted at the last minute to raise the debt ceiling and set up a super committee to cut spending, but the super committee couldn't figure out how to cut spending, so now a bunch of automatic cuts are supposed to kick in."*

- Economists warn that the country could fall into another recession if a "fiscal cliff" isn't averted.
  - According to the CBO, allowing the fiscal cliff to occur could shrink the economy by as much as 3 percent in the first half of 2013, and reduce employment by one to two million.

- Three major concerns:
  1) Reduction in military spending leading to base closures -- direct and indirect impact on Virginia's economy.
  2) Reductions in federal contracts and research funding. Reflected in loss in revenue sources of business services – major employment sector, especially in Northern Virginia.
  3) Reductions in federal spending that directly affect state programs.

Key Dates in the Federal Fiscal Cliff 'Crash'

2012

- September: Continuing Resolution extends budget to March
- November: Elections
- December: 2001, 2003, 2010 tax cuts expire (e.g. income and capital gains rates, AMT patches, marriage penalty, estate tax)
- December: Smaller individual and business tax breaks expire
- December: Payroll tax 2% cut ends; unemployment insurance extension ends; 27% reduction in Medicare physician payments
- December: Reauthorizations

2013

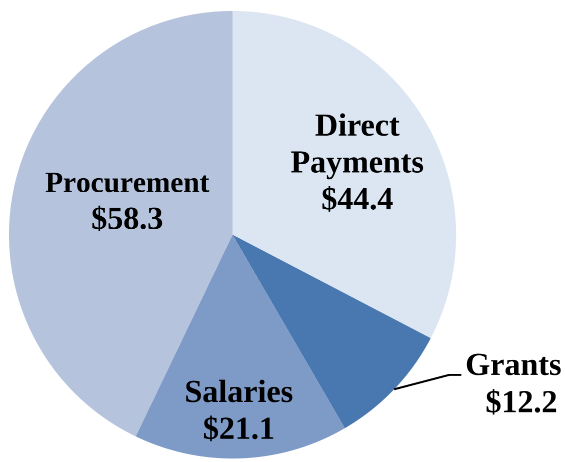
- January: $1.2 trillion in sequestration cuts activated, per Budget Control Act (BCA of 2011)
- February: Debt ceiling reaches the maximum again
- March: End of Continuing Resolution on the budget

"Fiscal Cliff"
What does it mean for Virginia?

- While Virginia receives less federal aid to state and local governments than any other state in the nation, Virginia is the number one recipient of federal procurement spending and federal defense spending on a per capita basis.
- Bond rating agencies have expressed concern about Virginia's dependence on federal funds. Moody's assigned Virginia a "negative outlook" in 2011; no change in position this year.

FY 2010 Federal Expenditure Data - Virginia

($ in billions)



“Not when, but cliff”

- ***Committee for a Responsible Federal Budget on the Budget Control Act:***
  - “It's too big, too quick, and focuses on the wrong parts of the budget…gradually phasing in well thought-out entitlement and tax reforms would be far preferable to large, blunt, and abrupt savings upfront.”
  - “Worst-case scenario: lawmakers repeal the sequester and extend expiring debt-expanding policies without offsetting costs.”
- If Congress acts, the General Assembly may be forced to deal with the impact during 2013 Session.
  - Have already set aside $30 million of surplus for Federal Action Contingency Fund.
  - **Planning is difficult, because we don’t know what cuts to expect.**
- Regardless of what happens with the “fiscal cliff”, it appears that Virginia can anticipate an ongoing contraction in federal spending.

In conclusion

- Slow economic growth, caution, uncertainty – watchwords for the next session as you amend the current biennial budget.
  - Keep an eye on new commitments that will complicate crafting the 2014-16 budget.
- Federal deficit reduction actions loom large.
  - How can Virginia position itself to respond?
  - How can Virginia diversify its economy to reduce dependence on federal spending?