2013 Session
Revenue Outlook

November 14, 2012

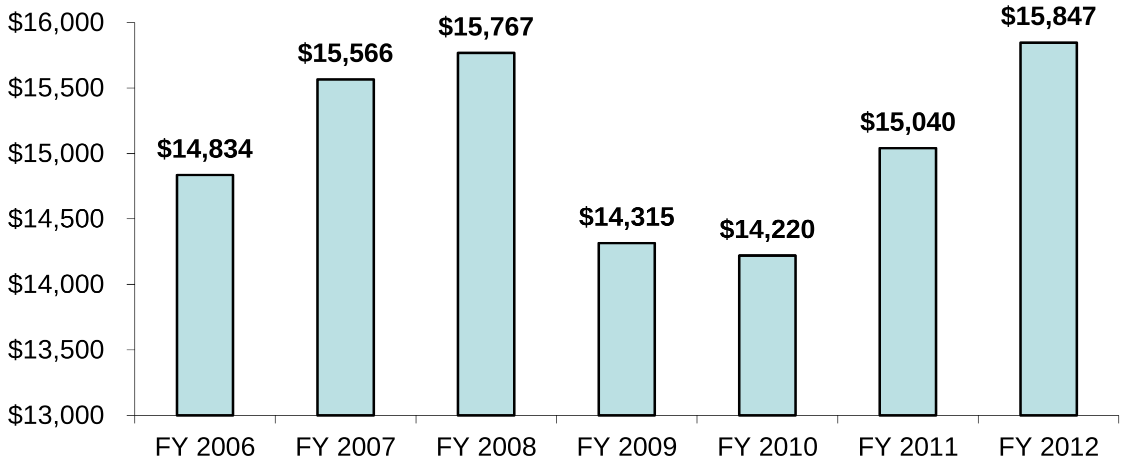
Virginia's Revenue Outlook: The overall backdrop. . .

- Economic outlook remains very close to what was projected last year, although updated economic variables show <u>slightly more softening</u> of growth.
  - Businesses and consumers remain cautious, awaiting more clarity on policy issues at home and abroad.
- Job growth will be anemic partly due to first step of Federal deficit reduction that already has occurred plus anticipation of what lies ahead.
- Virginia will perform below the nation due to heavy reliance on federal spending.
- On the positive side . . .
  - Housing activity has picked up and should provide "buffer" in both fiscal years 2013 and 2014.
  - FY 2014 could be better than expected as uncertainty diminishes *(any news can be better than no news).*

Looking Back: FY 2012 Revenue Performance

- In FY 2012, Virginia's revenues increased slightly more than projected, due to conservative forecasting.
  - 5.4 percent growth (second increase since FY 2008).
  - Brings us back to FY 2008 revenue collections.

GF Revenue Collections ($ in Millions)



- Collections exceeded the forecast by $123.1 million, or 0.8 percent.

Virginia's FY 2012 Revenue Performance

- Non-withholding and Refunds = largest variance
  - NWH final payments suffered from "payback" (compared to FY 2011 growth of 34 percent).
  - Refunds inflated during recession by about half a billion dollars; as economy improves, refunds drop.

GF Revenue Source	Percent of GF	Variance $ in millions
Withholding	65%	$ 33.7
Non-withholding	13%	(94.3)
Refunds	(14)%	147.1
Sales	22%	55.5
Corporate	6%	32.1
All other	8%	(51.0)
Total All	100%	$123.1

- Entire amount of revenue and part of unspent balances already are committed:

Major Commitments	$ in millions
Rainy Day Fund	$ 78.3
3.0% Salary Bonus	77.2
WQIF	16.9
TTF accelerated sales tax	20.9
Natural Disaster Sum Sufficient	17.2
Total All	$210.5

Impact of FY 2012 on Current Biennium

- If FY 2013 and FY 2014 growth rates adopted by last year's General Assembly remained unchanged:
  - Biennial revenue forecast would be increased by **$258.2 million**.
    - "Ripple effect" of higher FY 2012 revenue base.
- However, updated economic variables suggest a slight softening of growth for the biennium.
  - The $258.2 million "ripple effect" will be eroded to the degree that growth rates are revised downward.
  - Growth rates of 3.7 percent and 4.5 percent respectively were approved last session for the current biennium.

Virginia's FY 2013 First Quarter Performance

First Quarter Revenue Collections

- FY 2013 first quarter growth was 1.3 percent against 2.9 percent that is required to meet the official forecast.

- However, Q1 growth is short three deposit days, two of which will be regained in October and one of which will be regained at end of fiscal year.

GF Revenue Source	Percent of GF	YTD Growth Thru Sep	Required to Meet Forecast
Withholding	63.7%	(0.7)%	**3.5%**
Non-withholding	15.0%	4.1%	**3.6%**
Refunds	(11.8)%	(7.1)%	**7.8%**
Net Individual	66.9%	0.2%	**2.8%**
Sales	19.7%	10.4%	**2.8%**
Corporate	5.4%	(11.8)%	**3.0%**
Wills (Recordation)	2.0%	14.9%	**0.3%**
Insurance	1.8%	NA	**16.1%**
All Other	4.2%	(10.0)%	**2.1%**
Total	100.0%	1.3%	**2.9%**
Sales w/o AST		4.2%	**1.7%**
Total w/o AST		**0.4%**	**2.7%**

Modifications to Forecast

Updated Economic Variables

(National forecast, adjusted for Virginia specific data)

	Job Growth	Avg Wage/Salary Growth	Total Job + WS Growth	Income Growth
FY 2013				
Global Insight Std.	1.0%	2.5%	**3.5%**	**3.4%**
Global Insight Pess.	0.4%	2.4%	**2.8%**	**2.7%**
Moody's Econ.com	1.3%	3.4%	**4.8%**	**4.0%**
FY 2014				
Global Insight Std.	1.3%	2.4%	**3.8%**	**4.0%**
Global Insight Pess.	(0.2)%	2.2%	**2.0%**	**2.0%**
Moody's Econ.com	2.0%	4.9%	**7.0%**	**6.3%**

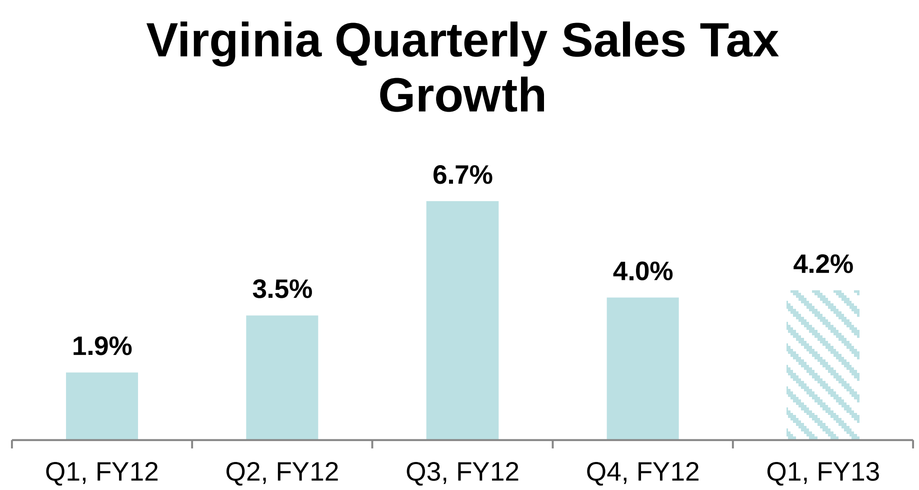
Withholding

- Q1 withholding growth is not a good gauge for where we will end up because of the three deposit day distortion.
- Using job growth between the Standard and Pessimistic outlooks would generate withholding at about the level required for the FY 2013 official forecast but would lower growth by 1 percentage point for FY 2014.

Modifications to Forecast

Sales Tax

- Q1 "economic" sales tax growth was 4.2 percent.
  - Sales tax collections have remained stable after gaining momentum last fall.
  - By year-end, the FY 2013 "economic" growth rate should weaken by about half a percentage point, due to comparison with last year's strong third quarter (includes Christmas sales).



- However, revised economic variables suggest that FY 2014 growth should be increased by about 1.0 percentage point.

Modifications to Forecast

Corporate and Non-withholding

- Most volatile and difficult to project; a large part of the collection pattern is driven by taxpayer behavior and tax planning (safe harbor).
  - Stock market performance figures in both sources.
- Corporate slowdown was expected in FY 2012; instead has shifted to FY 2013.

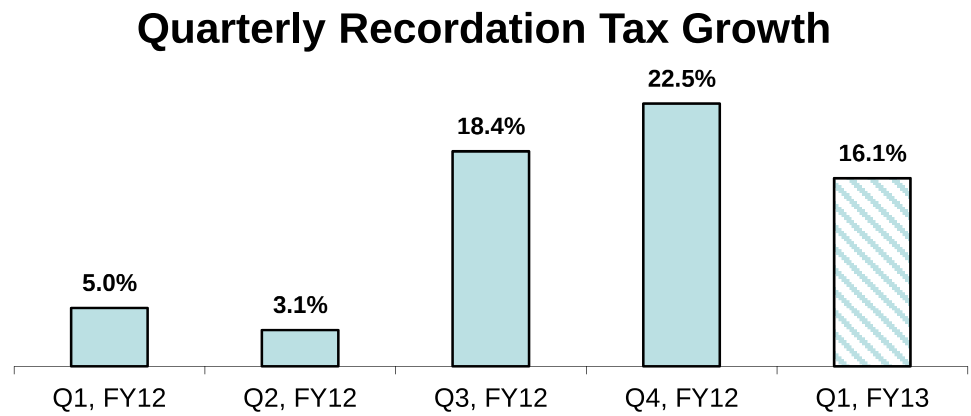
  - Payments down for large payers; up for small payers.
  - Slowdown of international growth?
  - Accelerated depreciation that ends in December?
  - Year-end capital gains push in other direction?
- Growth rate will be lowered for this year.

Modifications to Forecast

- Non-withholding payments rely about 60% on income and 40% on stock market performance.
  - Updated economic variables show lower growth in proprietor's income both years with some offsetting dividend growth;
  - Stock market should be positive factor this year.
- Growth rate for next year will be lowered.

Recordation Tax

- Growth at year-end will be close to Q1 growth; increase growth rate for both fiscal years.
  - Bright spot in forecast; finally price and sales of existing homes moving in same direction;
  - Recent substantial uptick in housing starts/permits will lend strength.



Short Session Revenue Adjustments FY 2012-14

SFC Staff Revenue Estimate of Forecast Changes

($ in millions)

	FY 2013	FY 2014
SFC Estimate	$16,425.5	$17,116.9
Current Official Forecast	$16,313.1	$17,041.7
GF Growth Rates	3.6%	4.2%
“Economic-based” Growth	3.5%	4.1%
Estimated Revenue Changes:		
Withholding	$ 9.6	$(78.8)
Non-withholding	(53.9)	(73.3)
Refunds (lower refunds = positive)	145.7	146.8
Sales	65.7	98.3
Corporate	(74.6)	(76.5)
Recordation	37.8	73.9
Insurance	(10.9)	(16.2)
All Other	(7.0)	1.0
Total Revenue Changes	**$112.4**	**$75.2**
Transfer change	$11.2	$13.6
Total Revenue and Transfers	**$123.6**	**$88.8**

- Revenue plus transfer adjustments = $212.4 million.
  - Over a quarter of FY 2012 “ripple effect” was eroded.

What Else Could Color the Revenue Picture?

- About half of the Federal deficit reduction plan (Step One) was incorporated in the biennial revenue forecast presented last December and adopted by the General Assembly.
  - Final decisions about Step Two of deficit reduction and related timing will determine if other forecast adjustments are required in the current biennium.
  - The General Assembly has provided for a $50.0 million Federal Revenue Contingency Trust Fund (FACT) to hedge against potential adjustments.
    - $7.5 million available for BRAC-related activities;
    - Contingent draws, if funds not needed to offset cuts.
  - Due to timing, primary impact could be felt in building the next biennial budget.
- How Virginia ultimately fares under federal budget cuts will depend on what gets cut.
  - All cuts are not equal.

Federal Cuts: How Will Virginia Fare?

Basics of 2011 Budget Control Act:

- Step 1 = Statutory caps on discretionary spending.
  - $917 billion savings over 10 years, beginning in 2012;
  - Not part of "fiscal cliff" discussion;
  - **Impact already captured in Virginia's revenue forecast.**

- Step 2 = Automatic "sequester" of budget authority.
  - $1.2 trillion savings over 9 years, beginning January 2013;
  - Many large entitlement and family assistance programs exempted, i.e., Social Security and Medicaid.
  - Cuts applied half to defense and half to non-defense.
    - Defense Cuts: 9.4 percent for most programs.
    - Non-Defense Cuts: 8.2 percent for most programs; 2.0 percent Medicare.
    - **Cuts applied across-the-board for one year (FFY 2013);** subsequently, Congress would allocate cuts within defense/non-defense pots.

Federal Cuts: How Will Virginia Fare?

Current Landscape:

- All the players say they don't want automatic, across-the-board cuts in 2013.
  - Action needed by January to halt it;
  - March 27, 2013, *(when budget continuing resolution ends)* may be key date for reaching agreement on compromise;
  - Several things could happen in a compromise:
    - Start date could become 2014;
    - Cuts could start low and be increased over time;
    - Entitlements and tax reform will be part of discussion.
- So, if no one wants the current plan, why do we need to talk about cuts?
  - Step 1 of Federal deficit reduction is a fact; it already is reflected in Virginia's growth forecast;
  - Anticipation of Step 2 cuts is impacting hiring now;
    - NOVA share of job growth fell from 66 percent in FY 2011 to 48 percent in FY 2012; projected to be 36 percent in FY 2013.
  - Final compromise has to include additional cuts;
  - **Timing and what gets cut will matter most to states.**

Federal Cuts: How Will Virginia Fare?

- Why does it matter **<u>what</u>** gets cut?
  - Federal spending affects state economies differently, depending on concentration of:
    - Prime contractors;
    - Federal employees and military payroll;
    - Grant/contract awards.
  - Virginia's proximity to Washington and number of military bases reflects this fact.

Federal Spending	Va. Rank Per Capita
Procurement	#1
Salaries/Wages	#3
Grants	#48

Source: State Policy Reports; 2010 Consolidated Federal Funds Report

- Accordingly, Virginia's relative share of federal funds subject to cut is as follows:
  - Defense procurement/civilian salaries = 12.5 percent
  - Non-defense procurement/salaries = 7.3 percent
  - Grants = 1.8 percent

Federal Cuts: How Will Virginia Fare?

What This Tells Us:

- Obviously, Virginia would be better off if cuts are shifted from procurement and salaries to grants.
- Virginia would be somewhat better off if cuts are shifted from defense to non-defense.
- However, a key element is whether defense cuts are across-the-board (ATB) or targeted.
  - If ATB is abandoned, as expected, decisions about which defense systems or programs to curtail or delay will alter state results.
    - For example, decisions about the new F-35 fighter jet would not matter as much to Virginia as decisions about future shipbuilding.
    - In fact, decisions to delay new systems could actually benefit the states that produce the old ones.
- At the end of the day, Virginia's percentage of total defense spending likely will not tell the full story.

Federal Cuts: How Will Virginia Fare?

<u>How to Plan Without the Facts:</u>

- Focus on **<u>rough</u>** estimate of federal dollars that would be lost under FY 2013 "ATB sequester."
  - Discount that impact to reflect likely reality.
- About $7.4 billion might be at stake in Virginia.

Activity	$ Estimate	How Calculated
Defense	$4.5 billion	12.5% of total cut; reduced by 33% "leakage" for $'s spent outside Virginia
Non-Defense	$2.7 billion	7.3% of non-grant cuts
Grants	$142 million (Half passed through to local school divisions) Examples: Special Education At Risk Education (Title I) Head Start	Federal Funds Information for States
Competitive grants (98% Higher Education)	$50 million	Auditor of Public Accounts 2012 data

- So, how does this translate to jobs?

Federal Cuts: How Will Virginia Fare?

- Most quoted jobs estimate was prepared for Aerospace Industries Association (July 2012).
  - GMU Center for Regional Analysis with Chmura Economics & Analytics:
    - Estimated potential job loss of 202,571 under Budget Control Act (defense + non-defense);
    - **Includes both Step 1 and Step 2** of Budget Control Act; news accounts often mistakenly attributed job number to Step 2 across-the-board "sequester";
    - Roughly 55 percent of job loss = prime contractors/their supply chain and federal civilian employees;
    - Remaining 45 percent of job loss = **"induced"** or the multiplier effect of less money being spent in restaurants, retail stores, etc.
- More recent report by Chmura to "fine tune" potential Virginia job loss for Economic Development Partnership took it down by 20 percent to 164,225 jobs.
- Key Points:
  - A major part of the job loss already has been assumed in Virginia's revenue forecast.
  - Job numbers cited above are worst-case scenario; compromise plan will have lower cuts.

Federal Cuts: How Will Virginia Fare?

One Approach Until Clarity is Added:

- Make two basic assumptions:
  - Assume that non-entitlement cuts in a Step Two compromise plan would equal about half of the solution;
    - Latest Chmura report assumes that compromise plan could reduce job losses by over 60 percent.
  - Assume that initial revenue analysis should focus on direct and indirect job losses rather than "induced" job losses that might result from lower restaurant/retail spending down the road.
    - In reality, some of the at-risk highly-skilled jobs will be absorbed in other areas.
- Under these assumptions, exposure that is not already captured in Virginia's revised revenue forecast could be in the range of 18,000 to 24,000 jobs.

Federal Cuts: How Will Virginia Fare?

- Virginia's additional state revenue impact could be in range of $72 to $96 million; however, timing is crucial.
  - All job losses don't occur on the same day;
  - A Federal FY 2014 job loss would have less than a full year impact on the state budget (nine months or less);
  - If, on average, remaining job losses generate six months of lost revenue in the current biennium, roughly $36 to $48 million of exposure could fall in FY 2014.
- However, the General Assembly already has approved a contingency plan that is sufficient to deal with the possible additional revenue loss.
  - Federal Action Contingency Trust Fund (FACT) provides a hedge against lost federal funds.
    - $30 million from FY 2011 balances;
    - $20 million from FY 2013 balances.

Federal Cuts: How Will Virginia Fare?

- Until final details of a compromise plan to produce $1.2 trillion for Step Two of the Budget Control Act are known, further budget action does not appear to be needed in Virginia.

- At this juncture, perhaps the most productive activity for policy makers is to focus on ways to mitigate potential job losses, whatever number materializes:
  - Small businesses that provide goods and services to prime contractors seem most at risk;
  - Business and individual retooling will be required.