

SENATE OF VIRGINIA

Senate Finance Committee

2014 Session Revenue and Budget Outlook

November 21, 2013



SENATE FINANCE COMMITTEE

Outlook for the 2014 Session

- Virginia’s economic outlook for the next two years will be characterized by slow growth and uncertainty.
 - Last three years have produced revenue growth above five percent, yet still below pre-recession trend.
 - Virginia’s economy will likely underperform the national economy over the next two years.
- Recent efforts to return to “structural balance” will make it easier to craft the 2014-16 biennial budget.
 - Most one-time resources or “gimmicks” have been corrected or are being phased-out.
- Slow revenue growth, combined with the impact of tax policy actions, reduces budget flexibility.



Outlook for the 2014 Session

The song remains the same...

- Fall, 2011 – Budget Control Act signed; Super Committee failed to act.
 - Fall, 2012 – “Fiscal Cliff” looming.
 - Fall, 2013 – Federal budget shutdown.
 - February, 2014 – Continuing Resolution on the budget expires, debt ceiling reached.
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- Sequestration – not the poison pill it was thought to be. Federal spending cuts proving to be less onerous than raising taxes or cutting entitlements.
 - Cuts in federal defense spending appear to be a sure thing.
 - Impact of sequestration and shutdown reflected in FY 2013 actual and in FY 2014 revenues to date.



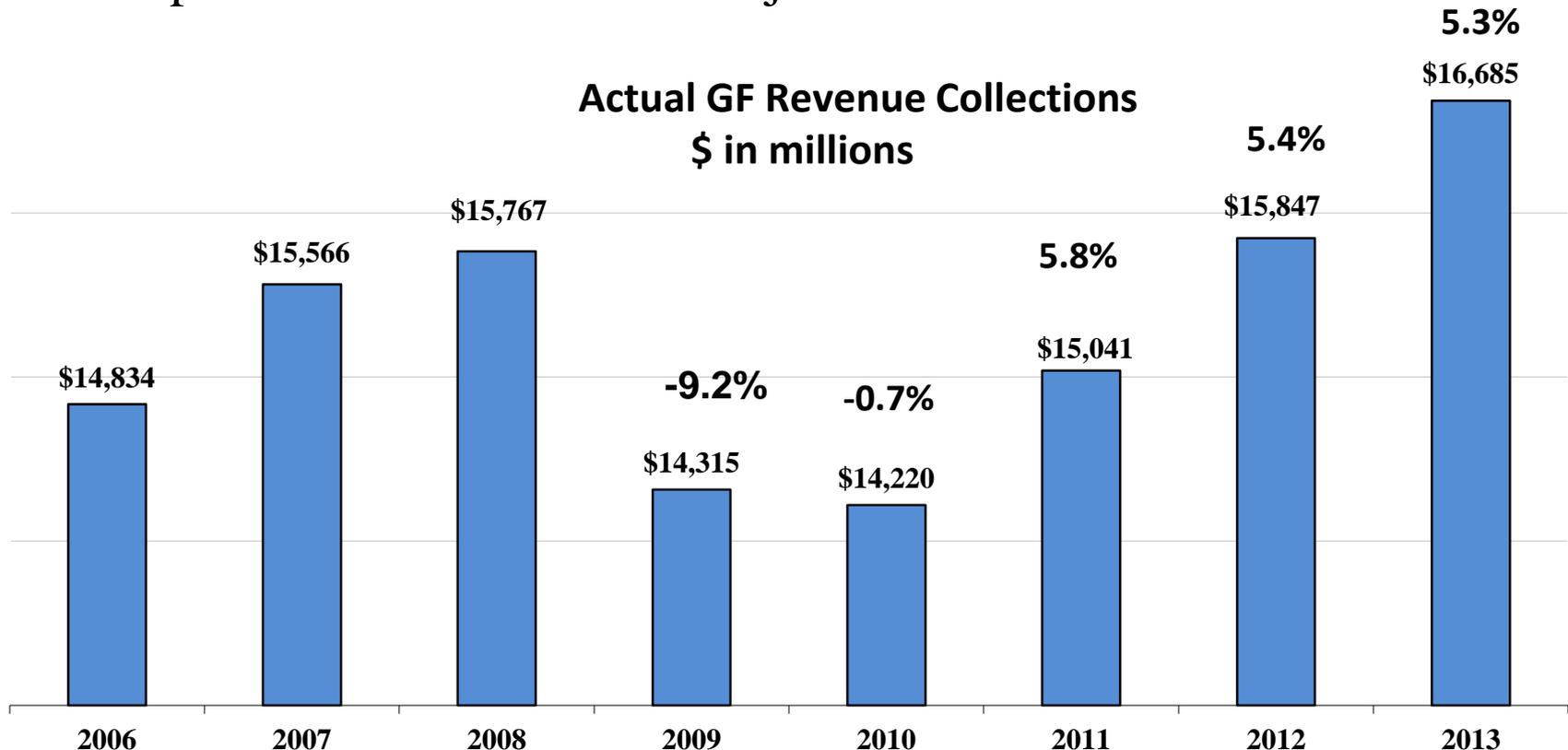
Bottom Line on the Budget Outlook

- Low growth conservative revenue forecast remains the order of the day -- growing, just very slowly.
- Projected revenue growth for the 2014-16 biennium should be sufficient to support the current operating base budget.
 - Available general fund resources above the base budget total about \$1.9 billion, plus about \$560 million in balances from FY 2014.
- Budget pressures from high-priority, mandated programs – including Medicaid, K-12 education, and VRS -- total about \$2.2 billion, consuming most of the resources and limiting flexibility.
- Uncertainty about the economy and action at the federal level calls for a continued cautious budget approach.



Looking Back: FY 2013 Revenue Performance

- Revenues grew 5.3%, ahead of the forecast of 3.6%. Collections exceeded the forecast by \$263.6 million, or 1.6%.
- Surplus masks weakness in major revenue sources.



FY 2013 Revenue Performance

- *Income tax withholding and sales tax fell short of the forecast.*
- Employment growth was stronger than expected, while personal income growth was weaker than expected.
- Anticipation of federal sequestration stymied job growth in the Professional and Business Services job series -- the highest paying jobs associated with federal procurement.
 - In NOVA, where 37 percent of jobs are located, the growth rate for this sector was half of the norm in FY 2013, and may be a third of norm in FY 2014.
 - Shift in growth toward lower-paying jobs in Education/Health, Leisure/Hospitality, and Construction depressed growth in average wages to about 1.7 percent, against a forecast of 2.5 percent.



FY 2013 Revenue Performance

- Sales tax fell below the forecast in 9 out of 12 months of the fiscal year as consumers cut back due to threat of sequestration and government layoffs.
- Shortfall offset largely by nonwithholding -- one of the most volatile revenue sources – from gains realized by taxpayers in anticipation of tax law changes.
- Performance in two key sources since sequester began:

	Withholding	Sales Tax
April	7.0%	0.0%
May	-1.8%	2.7%
June	-3.5%	0.7%
July *	19.6%	-5.5%
August	-5.5%	-5.6%
September	2.9%	-2.7%
<i>*Additional deposit day</i>		



FY 2013 Collections Over Forecast

GF Revenue Source	% of GF	Forecast % Growth	Actual % Growth	Variance \$ in millions
Withholding	64	3.3	2.1	\$ (115.0)
Nonwithholding	16	6.8	19.1	290.1
Refunds	(10)	0.4	(3.7)	72.2
Sales	19	4.1	3.1	(29.0)
Corporate	5	(4.5)	(7.3)	(24.2)
All other	<u>8</u>	<u>0.5</u>	<u>5.5</u>	<u>69.4</u>
Total	100%	3.6%	5.3%	\$ 263.6

- *Surplus and unallocated balances are already committed:*

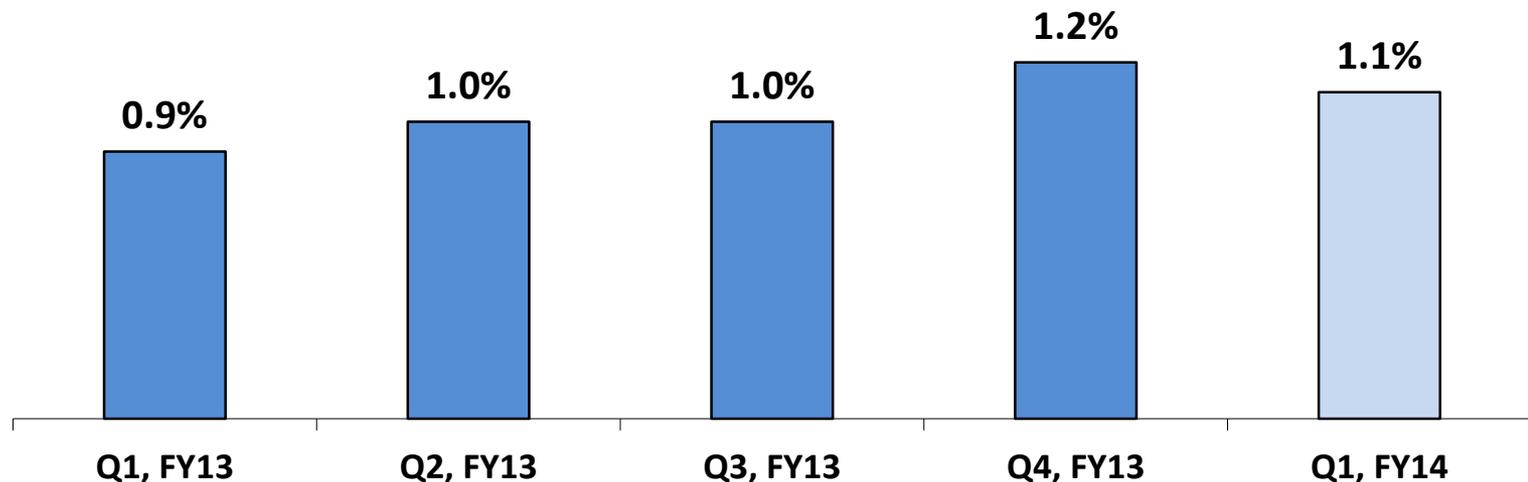
	\$ in millions
Rainy Day Fund	\$218.9
Water Quality Improvement Fund (Part A)	26.4
TTF Accelerated Sales Tax	21.7



FY 2014 Performance so far...

- FY 2014 budget assumed GF revenue growth of 3.8 percent; grew 2.8 percent in the first quarter.
 - Can meet the official forecast with 1.5 percent growth because revenue base has been increased due to FY 2013 actual collections.
- Slow job growth continues in the first quarter of FY 2014.

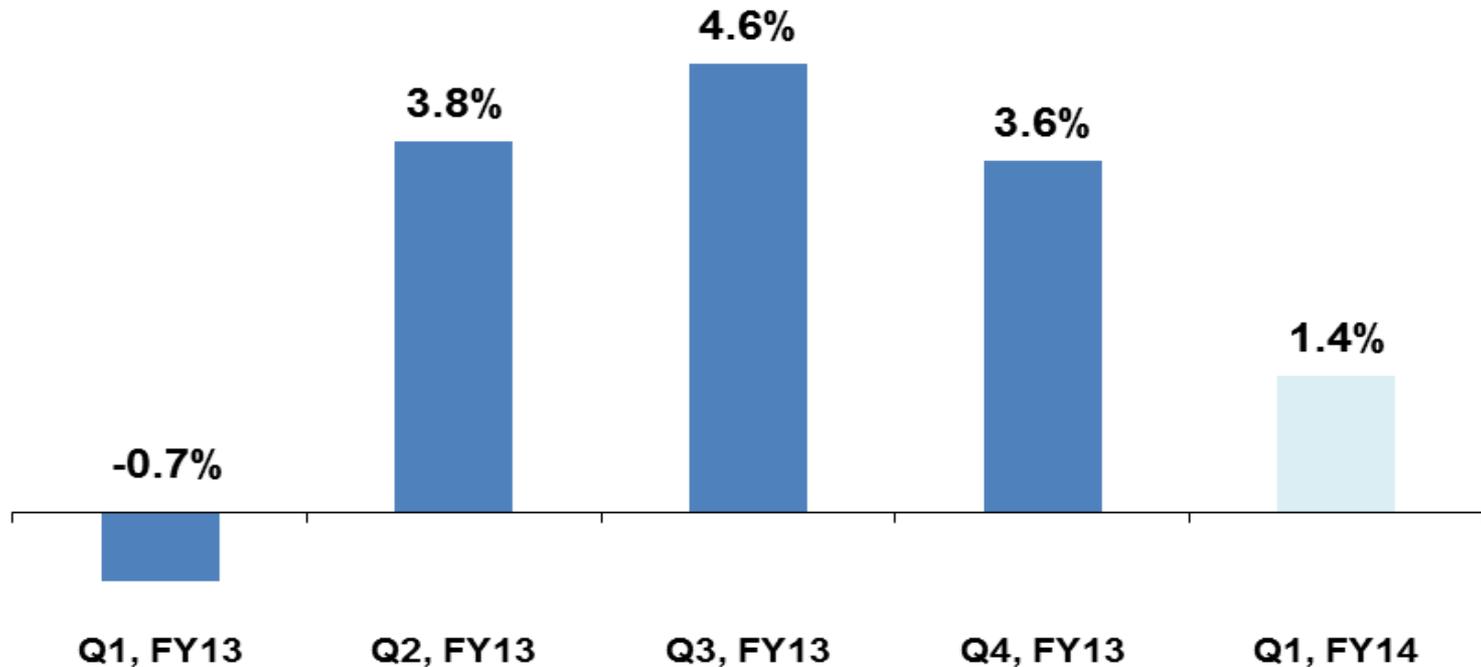
Virginia Quarterly Job Growth



FY 14 Performance Through First Quarter

- First-quarter withholding growth continues the FY 2013 trend.

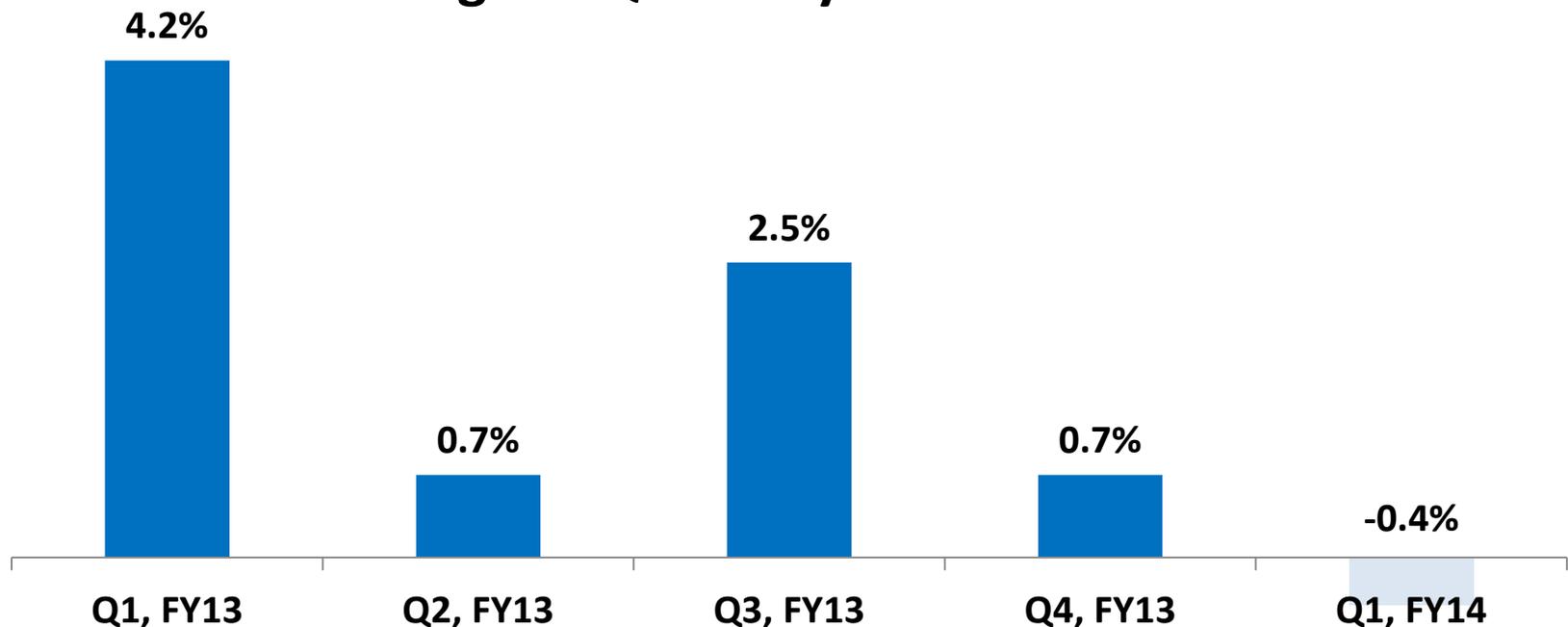
Virginia Quarterly Withholding Growth



FY 14 Performance Through First Quarter

- Sales tax performance has been soft nationally, negative since April in Virginia. Large retailers pessimistic about holiday sales.

Virginia Quarterly Sales Tax Growth



FY 2014 First Quarter Revenue Collections

GF Revenue Source	Percent of GF	Percent Growth Thru Sept.	Required by Forecast
Withholding	63.8	4.8	5.4
Non-withholding	15.6	2.9	(5.9)
Refunds	<u>(10.8)</u>	<u>20.8</u>	<u>6.3</u>
Net Individual	68.6	4.0	2.5
Sales	18.8	(4.5)	(1.0)
Corporate	5.0	19.4	5.4
Wills (Recordation)	2.0	2.8	(10.9)
Insurance	1.7	0.0	7.0
All Other	<u>4.0</u>	<u>(2.3)</u>	<u>(2.3)</u>
Total	100.0	2.8%	1.5%
Sales w/o HB2313		(0.4)%	5.2%
Total w/o HB2313		3.5%	1.4%



Adjustments to FY 2014 Forecast

- SFC staff suggests a modest upward adjustment to the current year forecast of about \$85 million.
- As with FY 2013, positive activity in secondary revenue sources offsets slower growth in key sources.
 - Downward revisions to withholding and sales tax.
 - Downward revision to corporate based on FY 2013 actual and higher refund activity in October.
 - Upward revision to nonwithholding (2.9% first quarter; grew 19.1% in FY 2013 against a forecast of 6.8%).
 - Slight upward adjustment to recordation tax.
 - Downward adjustment to refunds (positive impact on GF).



Consensus Revenue Forecasting Process

- Joint Advisory Board of Economists (JABE) - meets late October.
 - Economists from private sector and academia; input from Global Insights and Moody's Economy.com.
 - Dept. of Taxation and Secretary of Finance develop forecast based on input.
- Governor's Advisory Committee on Revenue Estimates (GACRE) - meets late November.
 - Cross-section of leaders from Virginia business and industry, General Assembly leadership.
 - Members react to forecast developed by Governor's staff.
- Official forecast proposed in Governor's budget as introduced.
 - Modified by tax policy changes adopted through legislation.
 - Changes in assumptions adopted by money committees in the budget.



Virginia's Revenue Outlook: Turning to the 2014-16 Biennium

- About 87% of GF revenue comes from individual income and sales tax.
- NOVA will continue to be a drag on growth as federal budget cuts play out, as reflected in job and wage growth.

Projected Economic Variables

(National forecast, adjusted for Virginia specific data, October 2013)

	<u>Job Growth</u>	<u>Average Wage/Salary Growth</u>	<u>Total Wage/Salary Growth</u>	<u>Income Growth</u>
FY 2015				
Global Insight Std	1.5%	2.5%	4.1%	4.5%
Global Insight Pess.	0.1%	2.3%	2.3%	2.8%
FY 2016				
Global Insight Std	1.6%	2.5%	4.1%	4.4%
Global Insight Pess.	0.6%	2.5%	3.1%	3.4%



2014-16 Biennium Revenue Outlook

- Reflecting the continued impact of sequestration, **withholding** growth likely will remain in the 4 percent range.
 - To date, most of the impact of sequestration has been in jobs that didn't materialize, or furloughs.
- Job growth will be there: “It's just that we need two jobs for every one of the jobs we used to have because the new jobs won't pay as well.” (Steve Fuller, GMU).
 - Federal spending will still be a big part of our economy, but it won't be the driver. Growth sectors that will replace it will pay less.
 - High-earning baby boomers are retiring and being replaced by lower earning younger workers.
- Strong growth in construction industry is a bright spot, although lower-paying jobs.

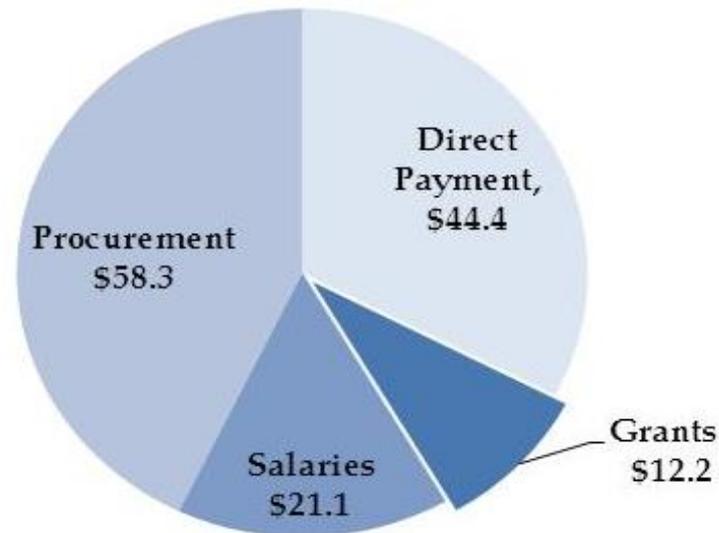


Federal Budget Debate – what does it mean for Virginia?

- Procurement/DOD civilian payroll most at risk
- Virginia #2 in DOD procurement spending
- Virginia #1 in DOD civilian payroll spending

FY 2010 Federal Expenditure Data - Virginia

\$ in billions



2014-16 Biennium Revenue Outlook

- Positive growth in the housing market and consumer demand for larger-ticket items will help drive the **sales tax** forecast.
- A forecast of 4 percent growth in personal income, adjusted for sales tax policy change, should generate growth of around 3 percent each year.
- Consumer confidence could be dampened by slow income growth, debt ceiling, and federal budget debacle.
- HB 2313 transfers about \$100 million in sales tax per year to transportation, lowering the forecast.
 - Half-cent dedicated to transportation phases up by .05% per year.



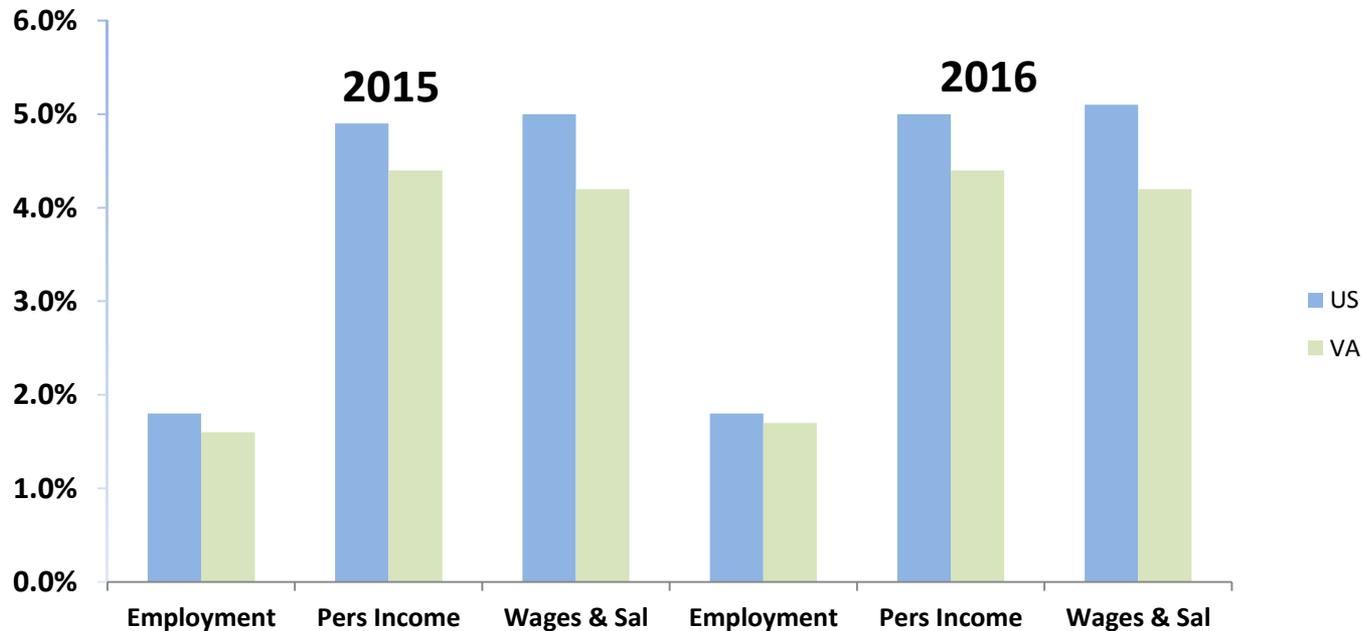
SFC Staff GF Revenue Estimate

	<u>FY 2014</u>	<u>FY 2015</u>	<u>FY 2016</u>
Withholding	3.3%	4.4%	4.5%
Non-withholding	2.5%	4.3%	3.2%
Refunds	0.8%	3.3%	4.1%
Sales Tax	(3.5%)	3.8%	2.9%
Corporate	1.0%	0.4%	0.9%
Wills, Suits, Deeds	4.0%	6.2%	5.4%
Other	<u>2.3%</u>	<u>0.1%</u>	<u>1.8%</u>
GF Growth Rate	2.1%	4.1%	3.8%
GF “economic” growth	3.9%	4.5%	4.1%
Total GF Revenues	\$17,027.7	\$17,722.9	\$18,391.4
Transfers	\$559.2	\$582.2	\$599.9
Total GF Resources*	\$17,586.9	\$18,305.1	\$18,991.3
<i>*Reflects HB 2313</i>			



Outlook for the 2014-16 Biennium

- Uncertainty requires that Virginia's revenue forecast continue to be conservative.
- Employment, personal income, and wages and salaries will likely underperform the U.S. in FY 14 and in each year of the next biennium.



Outlook for the 2014-16 Biennium

- Not seeing a return to trend growth in revenues.
- In addition, the full impact of several tax policy actions will be reflected in 2014-16 revenues, reducing general fund revenues by about \$165 million per year.
 - HB2313 (2013) – Transportation -- about \$100 million/year.
 - HB2437 (2009) – Single Sales Factor Apportionment – about \$40 million/year (\$18 million assumed in FY 2014).
 - SB131/HB321 (2012) – Educational Improvement Scholarships Tax Credit -- up to \$25 million/year.



Developing the 2014-16 Budget

Recent efforts to return to “structural balance” will make it easier to craft the 2014-16 biennial budget.

- Minimizing the use of budget “gimmicks”.
- Rebuilding cash balances – important to rating agencies.
- Addressing unfunded liabilities.
- Setting-aside future required payments for the Rainy Day Fund; creating FACT fund as cushion against sequester.
- Addressing growth in high-cost programs.
- Routinely funding employee salary increases.



Improving “Structural Balance”

Eliminating one-time savings and revenue sources -- “budget gimmicks”.

- Reduced the Accelerated Sales Tax by \$50.0 million in FY 2012, and another \$20.8 million in FY 2014; 98 percent of retail merchants no longer transmitting sales tax early.
- Completely eliminated \$60 million Aid to Localities Reversion.
- Fully-funded items in the second year (mostly).
- Eliminated or began phase-out of “budget balancers” (VRS underfunding, higher education vacancy reversions, diversion of NGF interest).



Addressing Unfunded Liabilities

Stabilizing and strengthening the Virginia Retirement System.

Pension Reform

- | | |
|------|---|
| 2010 | <ul style="list-style-type: none">• “Plan 2” status created for new employees (age, Avg. Final Comp., COLA) |
| 2011 | <ul style="list-style-type: none">• State employees to pay 5 percent employee share (offsetting increase)• Updated JLARC study |
| 2012 | <ul style="list-style-type: none">• Hybrid combination Defined Benefit-Defined Contribution plan created for new employees• Phase-in over six years to full-funding of the actuarially recommended contribution rates• Plan 1 changes for non-vested employees• Local and school employees to pay the 5 percent employee share |

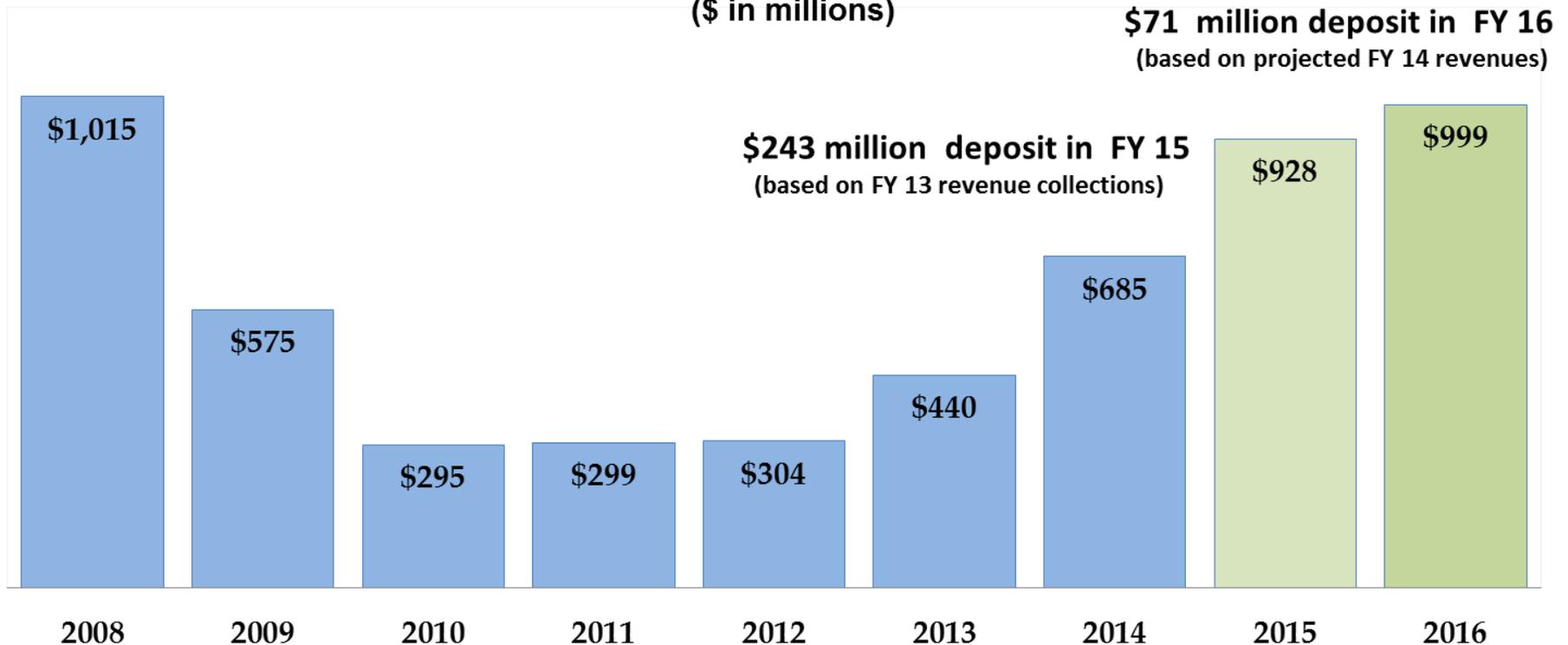
- Moody’s Investors Service issued a notice citing Virginia’s pension reforms as a “credit positive.”



Rebuilding the Rainy Day Fund

Balance approaches \$1.0 billion with two additional deposits.

Rainy Day Fund Balance
(\$ in millions)



Developing the 2014-16 biennial base budget

- **Base budget** = cost of maintaining **current** services and caseloads.
- **One-time** spending items are **deducted** from the FY 2014 appropriation (RDF deposits). On-going items that are **not fully funded** in FY 2014 are **added** to the base (partial-year salary increase and prison opening).

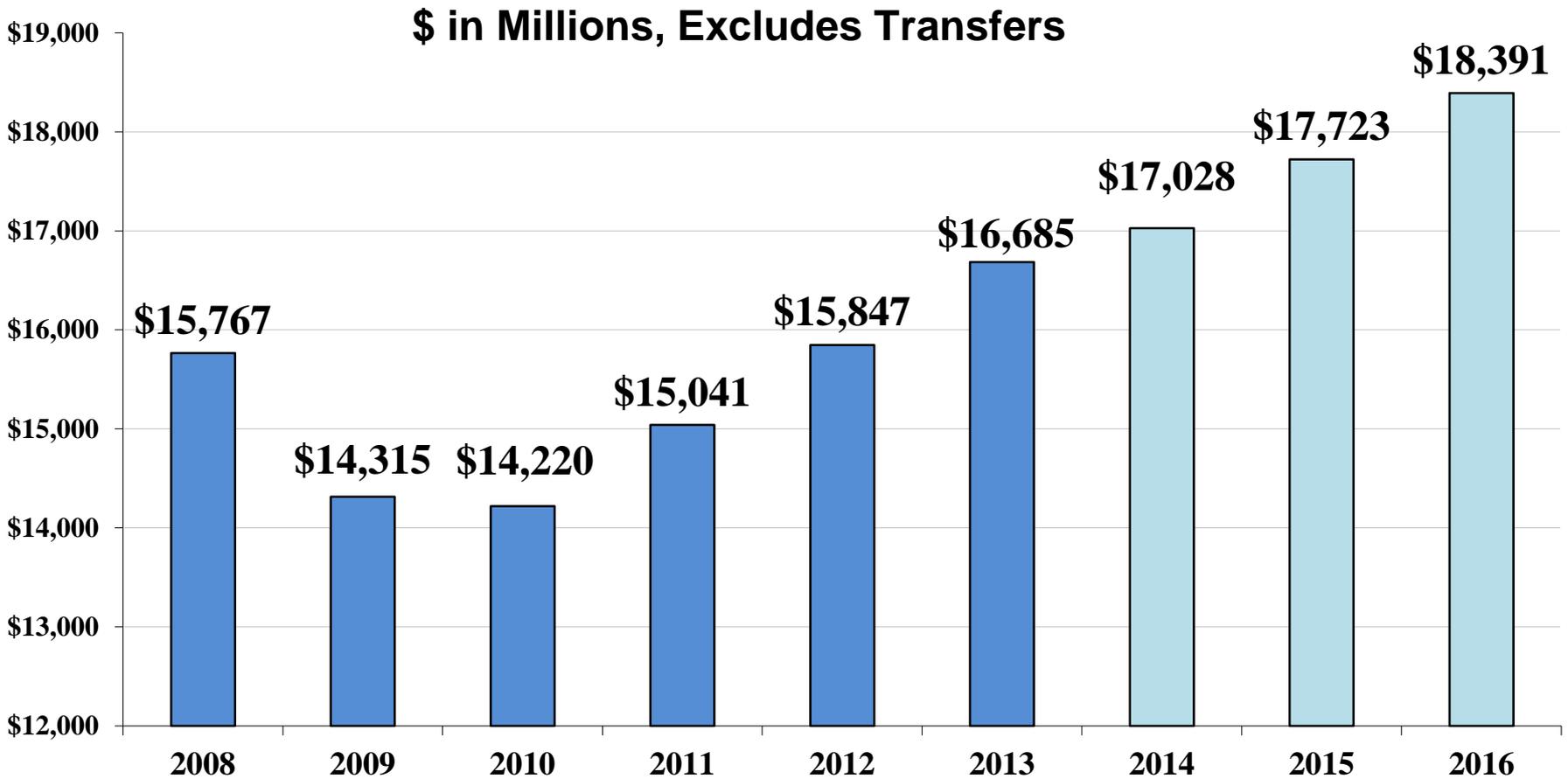
2014-16 GF Base Budget Calculation

(\$ in millions)

Ch. 806, FY 2014 GF Operating x 2	\$35,972.2
Minus: One-time Spending	(\$607.2)
Plus: Technical Adjustments	<u>\$66.4</u>
Total, Adjustments to Base	(\$540.8)
SFC Biennial (Two-Year) GF Base	\$35,431.4



Actual and SFC Projected GF Revenues



Developing the 2014-16 Budget

Comparing projected resources to the current base budget.

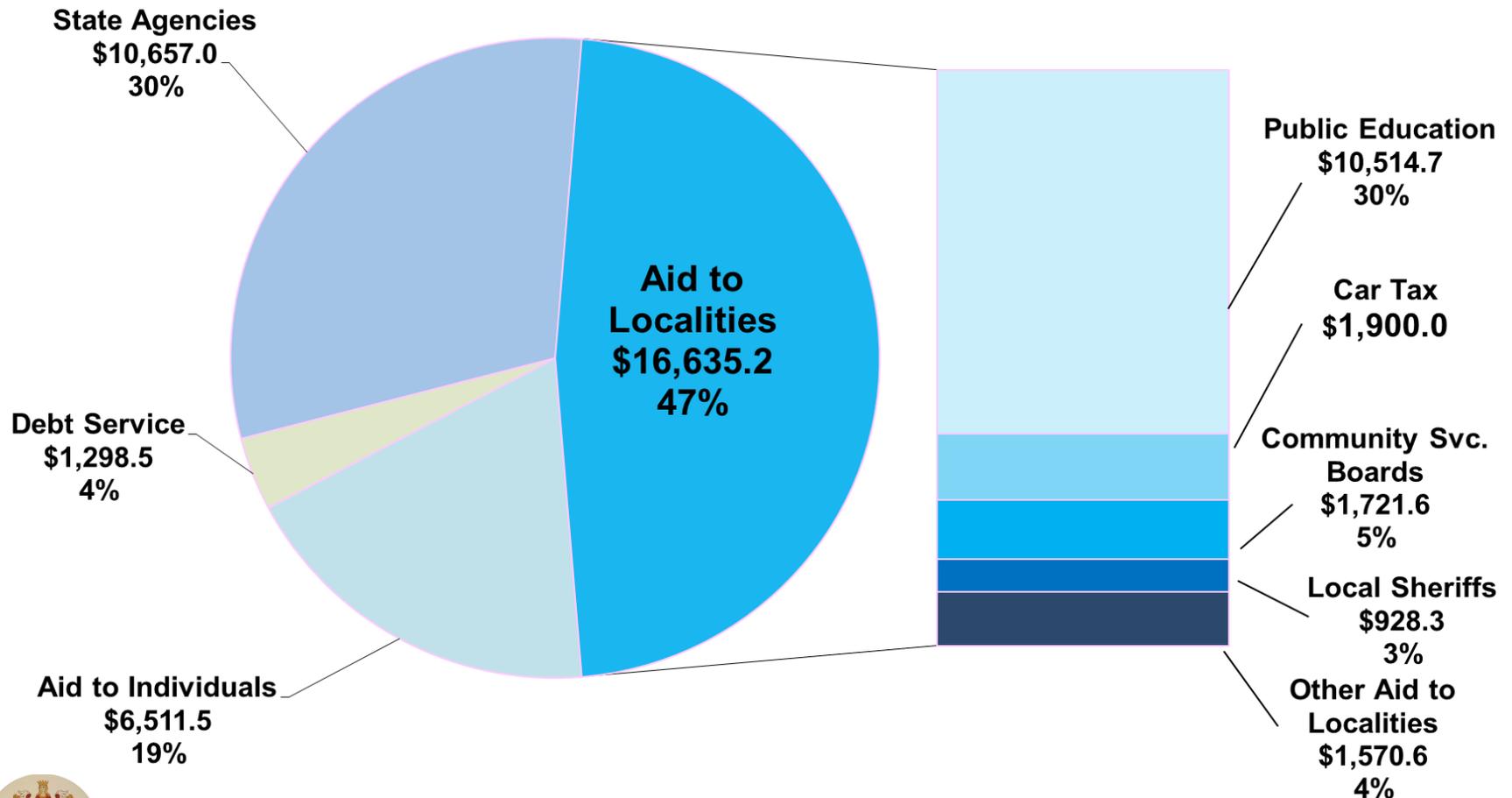
(\$ in millions)	<u>FY 2015</u>	<u>FY 2016</u>	<u>2014-16</u>
Revenue Growth Rates	4.1%	3.8%	
SFC Staff Forecast	\$17,722.9	\$18,391.4	\$36,114.3
Transfers	<u>582.2</u>	<u>599.9</u>	<u>1,182.1</u>
Total GF Resources	\$18,305.1	\$18,991.4	\$37,296.4
GF Base Budget	\$17,763.2	\$17,668.2	\$35,431.4
Resources Above Base	\$541.9	\$1,323.2	\$1,865.1
Balance from FY 2014	<u>566.7</u>	<u>0.0</u>	<u>566.7</u>
<i>Resources Available</i>	<i>\$1,108.6</i>	<i>\$1,323.2</i>	<i>\$2,431.8</i>



General Fund Budget Drivers

2012-2014 GF Operating Budget = \$35.1 Billion

Chapter 806 (\$ in millions)



2014-16 Budget Pressures

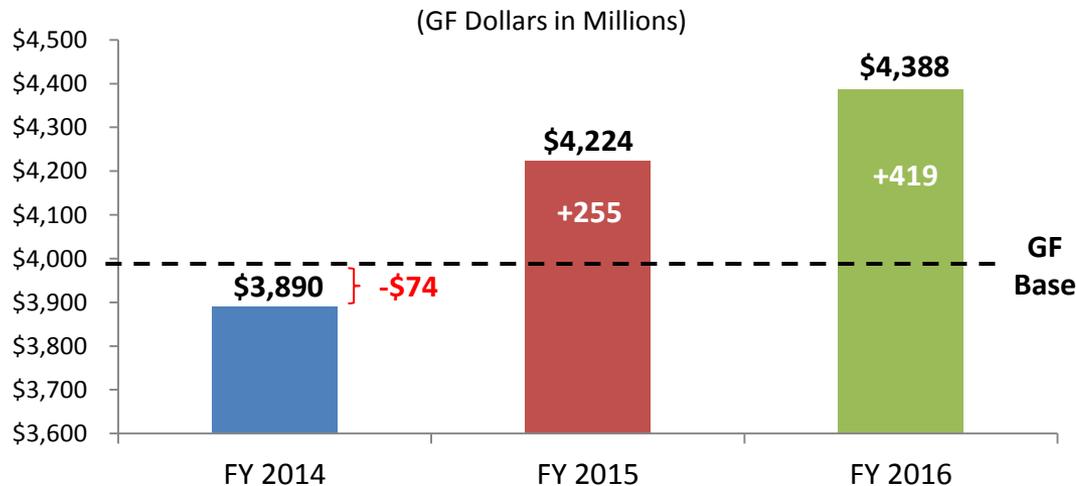
<i>(\$ in millions)</i>	<u>FY 2015</u>	<u>FY 2016</u>	<u>2014-16</u>
Medicaid Forecast	\$225.2	\$419.2	\$644.4
K-12 Rebenchmarking (incl. VRS)	280.7	325.2	605.9
Rainy Day Fund (+\$95m reserved)	148.2	70.8	219.0
Debt Service	75.0	100.0	175.0
VRS/OPEB – State Emp.	85.8	85.8	171.6
DOJ Settlement ID/DD Waivers	57.2	61.0	118.2
Other HHR (DSS, CSA, DBHDS)	28.9	29.9	58.8
Employee Health Insurance	26.8	26.8	53.6
Jail per diems, new jails, staffing	23.3	27.2	50.5
DOC Inmate Medical, operating	8.3	13.3	21.6
State Police – Operating	10.8	10.8	21.6
HE New Facilities On-line	8.7	12.7	21.4
Other (Ft. Monroe, DCJS, WQIF)	82.3	20.4	102.7
Savings (Lottery)	<u>(38.0)</u>	<u>(38.0)</u>	<u>(76.0)</u>
Total	\$1,023.2	\$1,165.1	\$2,188.3



Medicaid Forecast

- Additional funding of \$674.4 million required to address caseload and cost growth. Spending is expected to rise by 6.7% and 4.0% in FY 2015 and FY 2016, down from 8.5% and 7.3% in current biennium.
 - Payments made to Medicaid managed care organizations are expected to rise by 4% in FY 2015.
 - Annual enrollment growth continues to decline and is expected to average 2.5% in FY 2014 (compared to 10% in 2010).
 - Behavioral health services continue to experience significant growth.

November 2013 Medicaid Forecast



K-12 Rebenchmarking

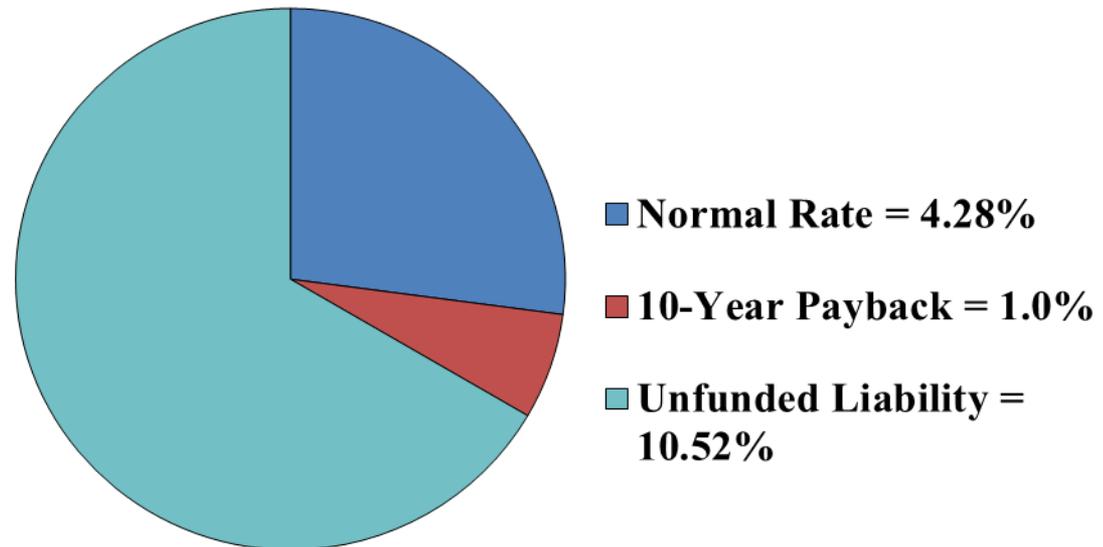
- Additional funding of about \$606 million for the biennium.
 - Partial estimate for rebenchmarking (as of September 26) of \$165.5 million in FY 2015 and \$185.2 million in FY 2016, reflects teacher salaries, health insurance, inflation, and textbooks.
 - \$84.5 million in FY 2015 and \$84.9 million in FY 2016 for VRS, Retiree Health Care Credit, and Group Life contribution rate increases.
 - \$18.4 million in FY 2015 and \$18.7 million in FY 2016 for updated Composite Index.
 - Projected Sales Tax growth and annual assumed savings from pre-K slots.
 - Other adjustments will include updated enrollment projections.



Three Components of the VRS Contribution Rates

- VRS funding requirements for the next biennium for state employees and teachers totals over \$300 million GF.

Components of the Full Employer Contribution Rate*



***Prior to application of the phase-in percentage**



Phased-In Schedule Mitigates Impact of VRS Contribution Rates

- The calculated full contribution rate will be phased-in consistent with the six-year schedule agreed upon in the 2012 VRS reform legislation (SB 498), to be fully funded beginning in FY 2019.

	Full Rate	Phased-In %	Phased-In Rate
State	15.8%	78%	12.3%
Teachers	18.2%	80%	14.5%
SPORS	32.9%	83%	27.6%
VaLORS	21.7%	84%	18.2%
Judicial	57.8%	89%	51.7%



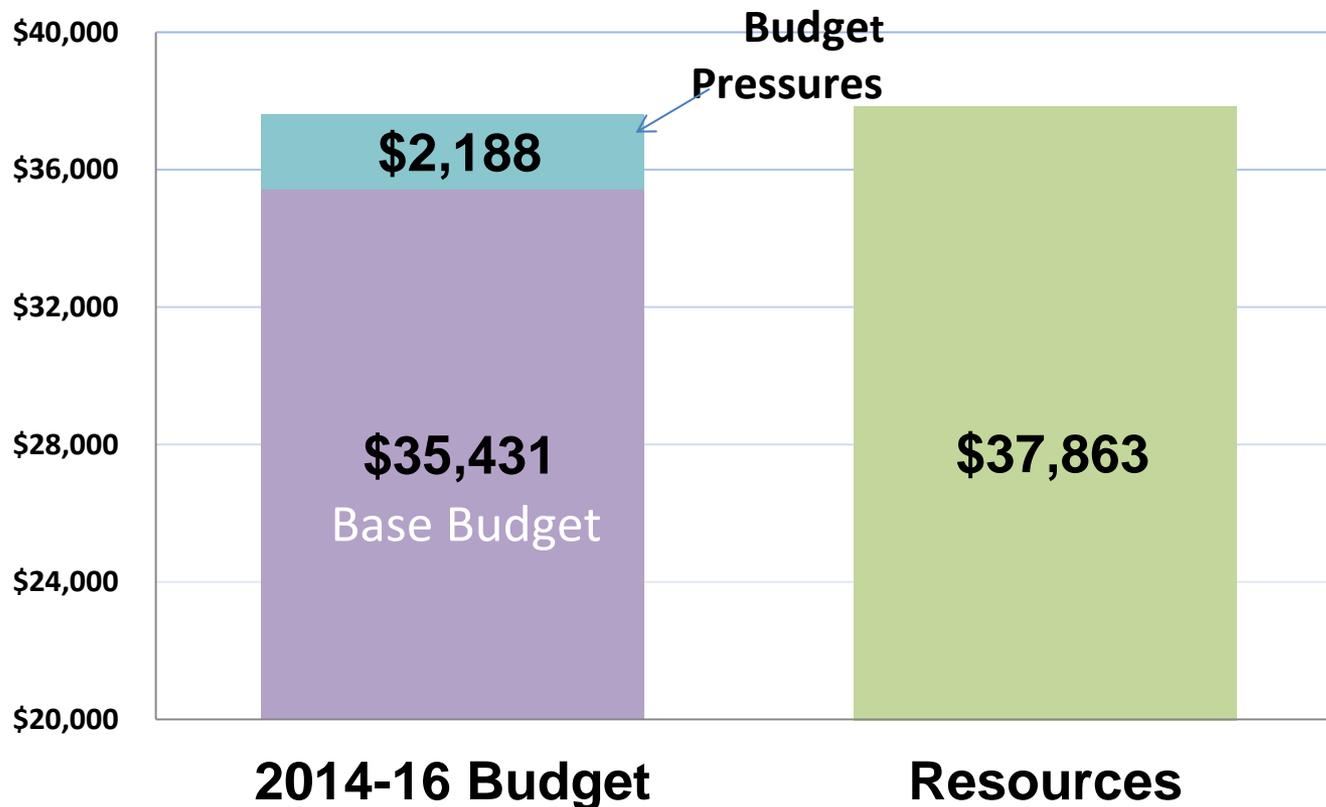
Other High-Priority Spending

- **Salary Increase** – 1 percent increase for classified state employees and state-supported locals = \$32.0 million GF per year.
- **Teacher Salary Increase** – 1 percent increase = \$39.1 million GF per year.
- **Higher Education** – Funding to implement “Top Jobs” legislation and promote degree production.
- **Faculty Salary Increase** – 1 percent increase = \$10.4 million GF per year.
- **Financial Aid** - \$19.7 million GF the first year and \$33.7 million GF the second year to maintain **current** level of aid.
- **Maintenance Reserve** – Funding of roughly \$55 million per year has been provided in recent years; could fund with debt.
- **Equipment for New Facilities Coming on Line** – About \$60.3 million; could fund with debt.



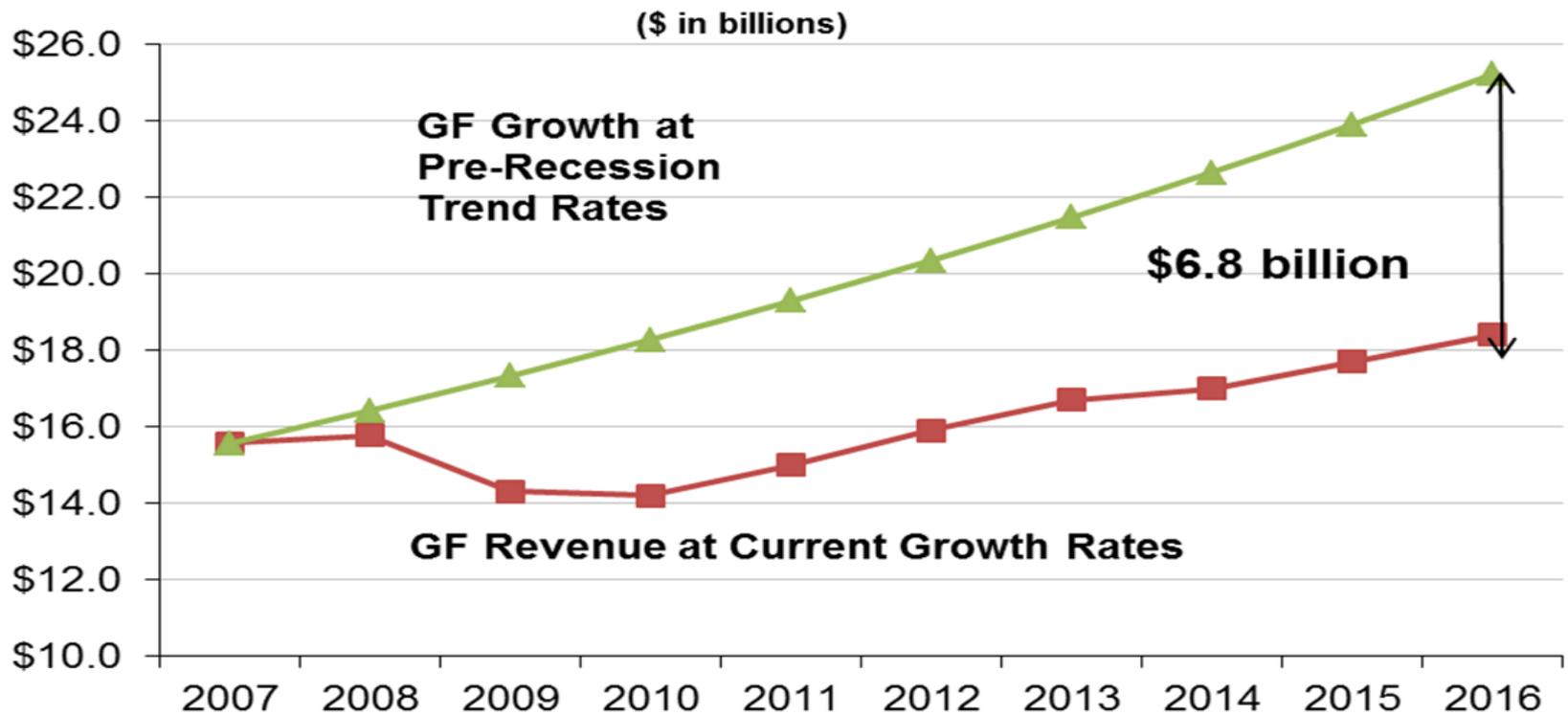
2014-16 Budget Outlook

- Resources will exceed mandated budget pressures by about \$200 million.
- Governor asked state agencies to develop budget reduction plans.



Slow growth continues

Expected growth rates of 4.1 percent in FY 2015 and 3.8 percent in FY 2016 lag historical pre-recession growth rates.



Challenges of the 2014 Session

- Uncertainty continues to color the national economic outlook and the revenue forecast for Virginia.
- Structurally, budget is in good shape.
- Revenue growth fairly flat, leaving little budget flexibility beyond funding the mandated, high priority spending pressures.
- Biggest unknown continues to be federal deficit reduction actions.



Sequestration Timeline

- **August 2, 2011:** Budget Control Act of 2011 (BCA) signed.
 - Joint Select “Super Committee” to develop budget.
- **November, 21, 2011:** Super Committee failed to act by November deadline, sequester triggered.
- **November, 2012:** “Fiscal cliff” loomed – expiration of major tax cuts and implementation of sequestration.
- **January 2, 2013:** American Taxpayer Relief Act of 2012 signed, sequester delayed until March, 2013.
- **March 6, 2013:** Continuing Resolution passed to fund government at current levels, adjusted by cuts for sequestration.
- **October 1, 2013:** Federal government shutdown for 16 days.



Sequestration Timeline

- **October 17, 2013:** President signed H.R. 2775, making continuing appropriations for FFY 2014. Ended the 16-day federal government shutdown. Provided appropriations until January 15, 2014, at final FFY 2013 levels.
- **December 13, 2013:** Congressional conference committee to issue recommendations for a long-term budget deal, potentially addressing mandatory spending, the ACA, amending or replacing the BCA, and tax reform.
- **January 15, 2014:** The current CR expires. OMB would issue a sequestration report pursuant to the BCA.
 - At current CR funding levels, domestic discretionary spending would not be subject to FY 2014 sequestration under the BCA. **Defense spending would.**
- **February 7, 2014:** Suspension of the debt ceiling expires.

