

# Senate Finance Committee

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## 2015 Session Revenue Outlook

November 20, 2014



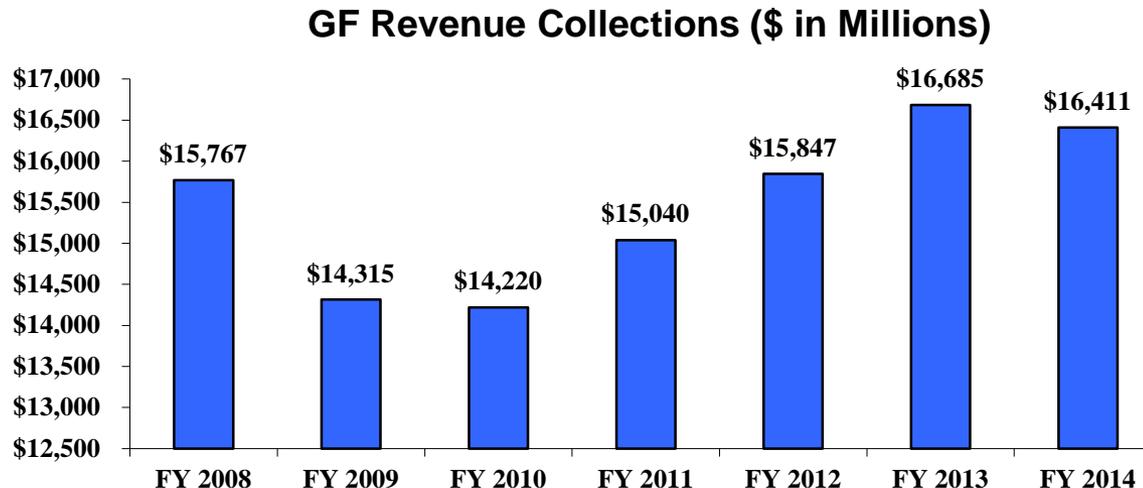
# Virginia's Revenue Outlook: The backdrop. . .

- Caution remains part of Virginia's budget vocabulary as the economic drag from constrained federal spending plays out.
  - The biennial revenue forecast presented last December had annual growth rates of about 4.0 percent versus average growth of 5.5 percent in recent years.
  - However, before moving into the new biennium, FY 2014 revenue fell short, triggering the development of a revised Interim Forecast.
- The Interim Forecast includes growth rates that are less than half of our long-term trend growth.
- A slight upward adjustment to the Interim Forecast is warranted based on “money in the bank.”
- However, this does not change the economic outlook.
  - Several economic and demographic factors will combine to keep us in the “not business as usual” mode for some time.



# Looking Back: FY 2014 Revenue Performance

- In FY 2014, Virginia's revenues were \$438.3 million short of the forecast.
  - \$401.1 million of the shortfall was mainly due to under-estimate of capital gains taken in advance of federal rate increase on high-income taxpayers.
    - Changes distribution of capital gains across tax years.
  - Overall, GF collections declined by 1.6 percent (almost half of the decline is from \$115 million of sales tax being reclassified from revenue to transfer under HB 2313 -- no change in GF bottom line).



# FY 2014 Collections Under Forecast

GF Revenue Source	Percent of GF	Variance \$ in millions
Withholding	64%	\$ (66.0)
Non-withholding	15%	(401.1)
Refunds	(11)%	51.3
Sales Tax	19%	(12.9)
Corporate Income Tax	5%	(12.4)
All other	<u>8%</u>	<u>3.1</u>
<b>Total All</b>	100%	<b>\$(438.0)</b>

- Withholding and sales tax collections weakened in second half of year.
- Total revenue growth of 1.7 percent had been expected (2.4 percent, if adjusted for reclassification of \$115 million in sales tax to transfer).
- This was a conservative growth rate, in anticipation of constrained federal spending.



# Impact of FY 2014 on Current Biennium

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- The FY 2014 revenue base, which is the starting point for forecasting the current biennial revenues, was short by \$438.0 million.
  - The “ripple effect” of this gap over the two-year budget, plus the absence of an expected balance rolled forward into FY 2015, created about a \$1.5 billion projected revenue gap.
- In addition, the economic variables underpinning the revenue forecast softened during the spring, taking the projected biennial revenue gap to \$2.4 billion.
- A revised, Interim Forecast was presented in August which reflects IHS Economics Pessimistic economic assumptions.



# Interim Forecast

- The table below shows the change in revenue growth rates that has occurred since last December.

<b>Evolving Growth Rates</b>	<b>FY 2014</b>	<b>FY 2015</b>	<b>FY 2016</b>
<b>Dec 2013 (Introduced Budget)</b>	1.7%	4.2%	3.9%
<b>Enacted Budgets</b>	1.0%	5.2%	4.1%
<b>Interim Forecast</b>		2.7%	2.7%
<b>Chapter 3 (November SS I)</b>		2.8%	2.6%

- An historical perspective on growth. . .

## **Average Revenue Growth Rates by Decade**

(Omits Recession Years)

<b>1980-89</b>	<b>1990-99</b>	<b>2000-09</b>	<b>2010-14</b>
<b>10.4%</b>	<b>7.5%</b>	<b>7.6%</b>	<b>3.9%</b>

- Revenue growth has trended down over time.
- In recent years, prior to 2014, growth averaged 5.5 percent.



# Interim Forecast

## May Economic Variables Assumed in Interim Forecast

(National forecast, adjusted for Virginia specific data)

	<u>Job Growth</u>	<u>Average Wage/Salary Growth</u>	<u>Total Job + WS Growth</u>	<u>Personal Income Growth</u>
<b>FY 2015</b>				
Virginia Interim Forecast	0.7%	2.5%	3.2%	3.7%
IHS Economics Pessimistic	0.6%	2.4%	3.0%	3.6%
<b>FY 2016</b>				
Virginia Interim Forecast	1.4%	2.1%	3.6%	3.8%
IHS Economics Pessimistic	0.9%	2.5%	3.4%	3.5%

- The revenue forecast rests heavily on total job plus wage/salary growth (3<sup>rd</sup> column) and growth in personal income.
- The question at hand is whether the Interim Forecast should be modified, based on updated economic variables and “dollars in the bank.”



# Modifications to Forecast

## Updated Economic Variables

	<u>Job Growth</u>	<u>Average Wage/Salary Growth</u>	<u>Total Job + WS Growth</u>	<u>Income Growth</u>
<b>FY 2015</b>				
Global Insight Pessimistic, May	0.6%	2.4%	3.0%	3.6%
Global Insight Pessimistic, Sept	1.0%	2.1%	3.1%	2.7%
<b>FY 2016</b>				
Global Insight Pessimistic, May	0.9%	2.5%	3.4%	3.5%
Global Insight Pessimistic, Sept	0.7%	2.6%	3.3%	2.8%

- Updated economic variables (Pessimistic Forecast) reflect two differences:
  - Total Job + Wage/Salary growth (predictor of income tax withholding) is slightly higher in FY 2015 and slightly lower in FY 2016.
    - Withholding represents 64 percent of revenue collections.
  - Personal Income growth (predictor of sales tax) is lower in both years.
    - Sales tax represents 19 percent of revenue collections.



# FY 2015 First Quarter Performance

- Next, “money in the bank” is used to test the updated economic variables.
- Q1 growth is 6.7 percent against required 2.8 percent.

GF Revenue Source	Percent of GF	YTD Growth Thru Sep	Required to Meet Forecast
<b>Withholding</b>	64%	6.3%	<b>2.7%</b>
<b>Non-withholding</b>	16%	14.7%	<b>6.3%</b>
<b>Refunds</b>	<u>(11)%</u>	<u>4.1%</u>	<u><b>3.6%</b></u>
<b>Net Individual</b>	69%	7.6%	<b>3.4%</b>
<b>Sales</b>	19%	4.6%	<b>2.8%</b>
<b>Corporate</b>	4%	12.4%	<b>(0.9)%</b>
<b>Wills (Recordation)</b>	2%	(6.1)%	<b>1.2%</b>
<b>Insurance</b>	2%	NA	<b>7.5%</b>
<b>All Other</b>	<u>4%</u>	<u>0.3%</u>	<u><b>(8.2)%</b></u>
<b>Total</b>	100.0%	<b>6.7%</b>	<b>2.8%</b>
<b>Sales w/o AST &amp; HB 2313</b>		<b>4.4%</b>	<b>3.4%</b>
<b>Total w/o AST &amp; HB 2313</b>		<b>6.3%</b>	<b>2.8%</b>

- Growth through October is 6.1 percent.

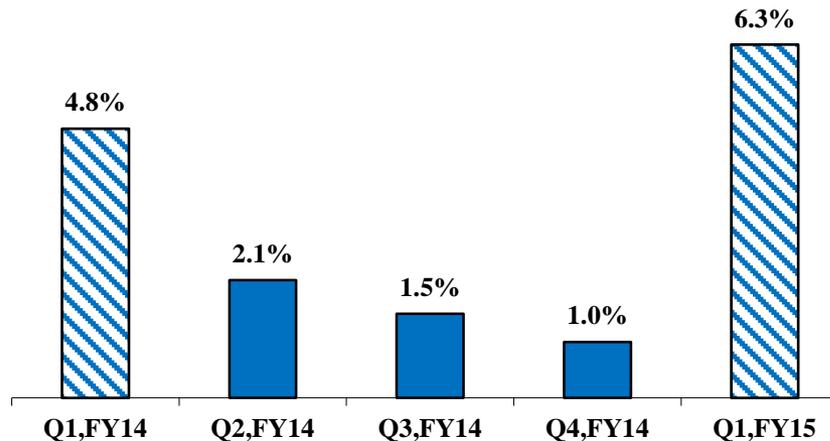


# Modifications to Forecast

## Withholding

- Strong withholding collections support an upward adjustment to forecast.

Virginia Quarterly Withholding Growth



- Withholding growth through October remains well above the forecast.
  - The Interim Forecast could be met with just 1.4 percent growth for the balance of FY 2015; that is lower growth than was achieved last year.



# Modifications to Forecast

## Nonwithholding

- Collections in both of the past two years were distorted by a shift in realized capital gains due to a federal tax policy change.
  - Taxpayers accelerated gains into tax year 2012, ahead of a tax rate increase, thereby inflating final payments in the spring of 2013.
  - FY 2014 forecast underestimated the extent of the acceleration.
  - Result was a larger than expected “correction” in FY 2014.
- Now that a “correction” has occurred, this year’s collection pattern should be more typical (60 percent driven by income and 40 percent driven by stock market).
  - YTD estimated payments signal slightly stronger growth than the Interim Forecast assumes.
  - Stock market should produce solid final payment growth.

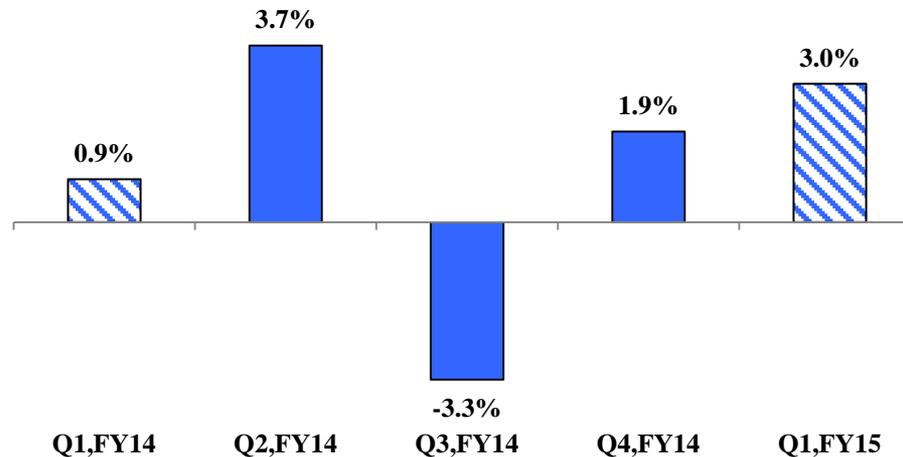


# Modifications to Forecast

## Sales Tax

- Sales tax growth (adjusted for AST & HB 2313) is slightly ahead of the Interim Forecast.

Virginia Quarterly Sales Tax Growth



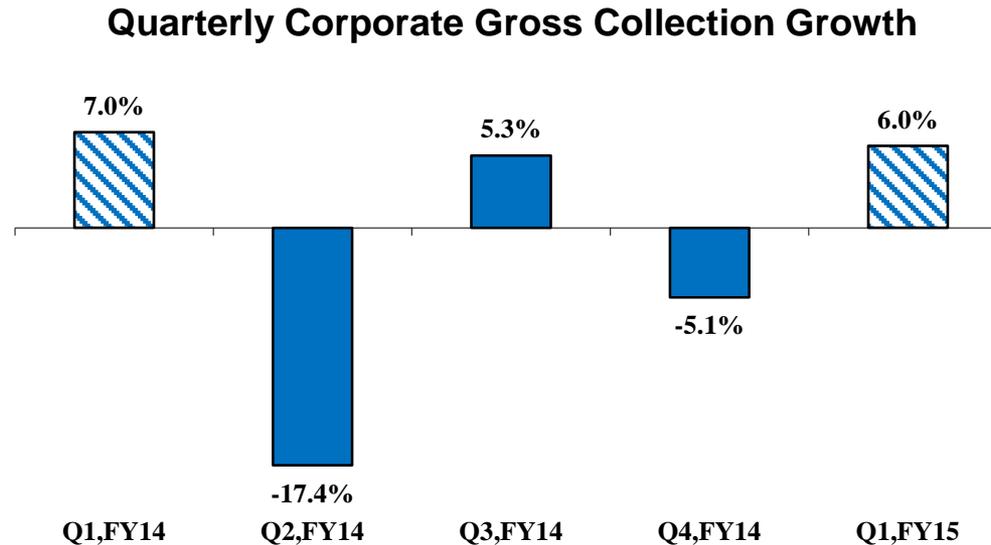
- However, the September Global Insight Pessimistic outlook suggests that sales growth will soften as the year progresses; therefore, the sales tax forecast should be reduced slightly.



# Modifications to Forecast

## Corporate

- Collections are influenced by tax planning and stock market, making it one of the more difficult sources to project.



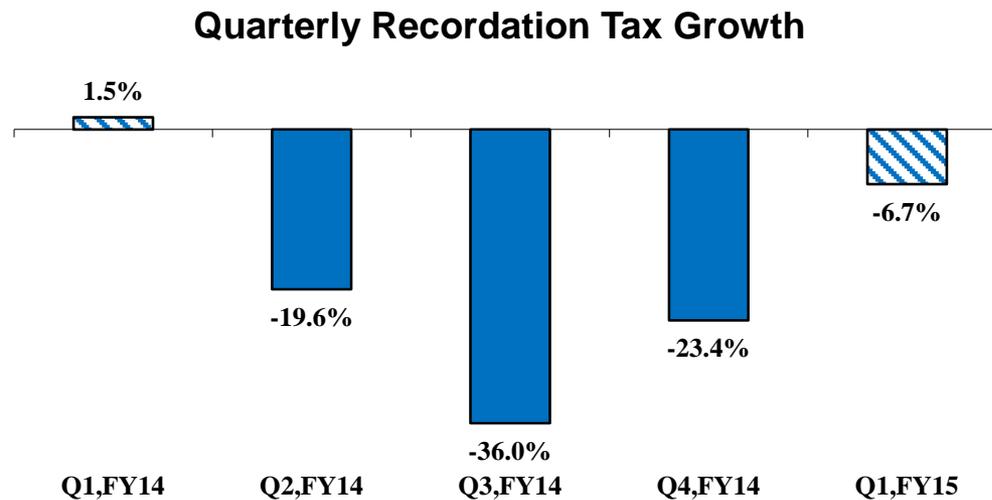
- Receipts through October were the highest level since FY 2008; gross collection and refund pattern suggest a slight upward revision to forecast.



# Modifications to Forecast

## Recordation Tax

- Following 13 months of negative growth, September and October registered gains of 1.2 percent and 10.5 percent respectively.
- FY 2015 should end with slightly positive growth, when compared with last year's "giveback" of sales increases from the prior two years.



# SFC Staff Estimate of Forecast Changes

	<u>FY 2015</u>	<u>FY 2016</u>
SFC GF Revenue Estimate	\$16,931.3	\$17,427.8
Interim Forecast (Chapter 3)	\$16,874.4	\$17,317.3
SFC GF Growth Rates	3.2%	2.9%
Interim Forecast Growth Rates	2.8%	2.6%
<b><u>SFC Estimate over (under) Interim:</u></b>		
Withholding	\$ 32.6	\$48.1
Non-withholding	24.2	51.5
Refunds (positive = lower refunds)	0.9	17.0
Sales	(13.7)	(57.9)
Corporate	19.6	10.0
Recordation	2.2	11.7
Insurance	(26.4)	5.3
All Other	<u>17.5</u>	<u>24.8</u>
<b>Total GF Revenue Changes</b>	<b>\$56.9</b>	<b>\$110.5</b>
<b>Transfers</b>	<b><u>(\$4.9)</u></b>	<b><u>(\$5.2)</u></b>
<b>Total GF Resource Change*</b>	<b>\$52.0</b>	<b>\$105.3</b>
*Potential ABC markup identified as option to address revenue loss reflected in Interim Forecast not included.		



# Economic Outlook Remains the Same

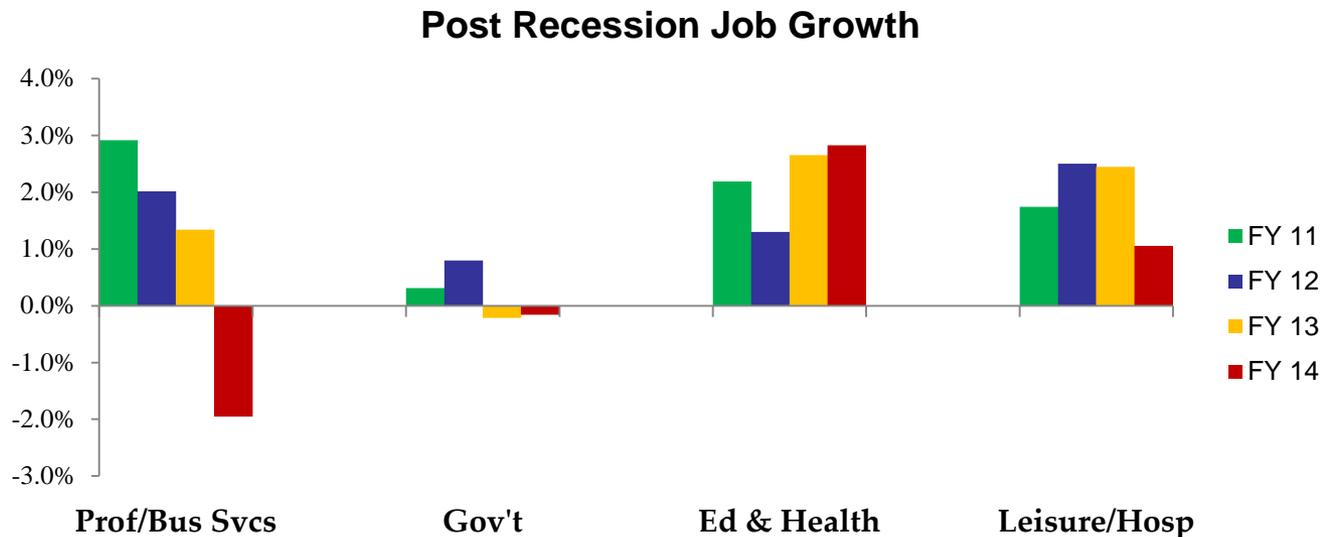
- **While a slight upward adjustment to the Interim Forecast is warranted, it does not mean that things have changed.**
  - It simply means that the Interim Forecast is slightly more pessimistic than it may need to be, given the most current data.
    - The Interim Forecast deviates from the normal practice of starting with the Standard Forecast (highest probability) and lowering it to hedge our bet (Standard Minus).
    - This time, the starting point is the Pessimistic Forecast, with slight upward revisions in certain areas (Pessimistic Plus).

	<b><u>Job Growth</u></b>	<b><u>Average Wage/Salary Growth</u></b>	<b><u>Total Job + WS Growth</u></b>	<b><u>Personal Income Growth</u></b>
<b>FY 2015</b>				
Virginia Interim Forecast	0.7%	2.5%	3.2%	3.7%
Global Insight Pessimistic	0.6%	2.4%	3.0%	3.6%
<b>FY 2016</b>				
Virginia Interim Forecast	1.4%	2.1%	3.6%	3.8%
Global Insight Pessimistic	0.9%	2.5%	3.4%	3.5%



# Economic Outlook Remains the Same

- **Wage growth remains sluggish, five years after the recession ended.**
  - Virginia’s revenue growth, which is driven almost 90 percent by individual income and sales tax, will remain below trend until this changes.
    - Virginia’s workers are impacted in general by sluggish wage growth.
    - In addition, Virginia’s mix of jobs has shifted toward lower paying ones, as defense contractors have “leaned out” their operations.



# Economic Outlook Remains the Same

- **Construction has not become the economic bright spot that was predicted a year ago.**
  - Home prices are approaching pre-recession levels, although prices currently are increasing in the single digit range.
  - After two years of healthy sales volume growth, FY 2014 saw a reversal of that pattern (one factor is a drop in investor demand).
  - Also, first-time home buyers continue to be a declining share of market.
    - Many young adults still live with parents.
    - Once they move out, it's hard to save for a down payment (high rent, student debt, perhaps less ability to get help from parents).
  - Some empty-nesters are choosing condos over single family homes.
  - There clearly is some pent up demand and with the wash-out of sales volume last year, we are positioned for sales to again increase.
  - But confidence, or lack thereof, makes the path uncertain for long-term purchase commitments.



# Economic Outlook Remains the Same

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- **Economic cycles may look different, but they have not gone away.**
  - The span between our past three recessions was 8 years, 10 years and 6 years.
  - We now are 5 years out from the official end of the “Great Recession.”
  - By the time Virginia’s economy regains its footing from defense-related woes, another national recession could be upon us.
- **Demographic realities are getting closer.**
  - A lot of workers will need to be replaced in the not so distant future.
  - Many workers who replace retirees will be paid less.
  - Retiree income that is taxed likely will not make up the difference.
    - Social Security is not taxed in Virginia.
    - Much of the retirement income beyond Social Security will not be taxed because Virginia allows low-to-middle income couples who are over 65 to qualify for a \$24,000 age deduction, in addition to enhanced personal exemptions.



# Not Business as Usual

- **Because of these factors, it is becoming increasingly important to think ahead of the curve.**
- An historical perspective on growth. . .

**Average Revenue Growth Rates by Decade**  
(Omits Recession Years)

1980-89	1990-99	2000-09	2010-14
10.4%	7.5%	7.6%	3.9%

- Revenue growth has trended down over time; in recent years, prior to 2014, growth averaged 5.5 percent.
- For the next two years, we are projecting growth below the four-year average shown above.



# Not Business as Usual

- **One aspect of revenue growth that is less apparent relates to tax preferences.**
  - They take tax revenue off the top and impact growth before budget decisions are made.
  - JLARC did a “whole earth” review of tax preferences in 2011.
- The Joint Subcommittee to Evaluate Tax Preferences has undertaken a systematic review of preferences.
- While there are many types of tax preferences on the books, those that most dramatically impact revenue growth are tax credits.
  - Provide a dollar-for-dollar reduction of tax liability.
  - Become a property right, once earned.
  - Are redeemed when it best suits the taxpayer, as opposed to when it best suits the state.



# Not Business as Usual

- For tax year 2011, \$458.2 million in tax credits were claimed on individual income tax returns.

## Estimated FY 2015 Impact of Tax Credits Enacted Since 1980

\$ in Millions

1980-89	1990-99	2000-09	2010-14	Cum. FY 15
(\$16.2)	(\$231.4)	(\$125.0)	(\$29.7)	(\$405.0)

## Average Revenue Growth Rates by Decade

(Omits Recession Years)

1980-89	1990-99	2000-09	2010-14
10.4%	7.5%	7.6%	3.9%

- The majority of tax credits were enacted when revenue growth was substantially above current growth.
  - If revenues continue to grow at about half the rate they were growing when these tax credits were adopted, it may be reasonable to consider scaling back the value of some credits.



# Not Business as Usual

- The Senate Finance Committee has adopted policies in recent years that could impact the growth of tax credits going forward.
  - New tax credits are considered only in even years when the biennial budget is being adopted;
  - Appropriation grants are preferred over tax credits because they provide more flexibility for the General Assembly in economic downturns;
  - New tax credits will not be refundable or transferable;
  - Fiscal impact analysis must show a future increase in revenue or budget savings.
- Yet, the large dollar volume of credits enacted between 1990 and 2009 continues to impact the budget every year.
- Appendix A contains a Tax Department estimate of the FY 2015 impact of these credits and other tax preferences enacted in recent years.



# APPENDIX A

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## **Selected Tax Measures Enacted Since 1990**



Source: Department of Taxation preliminary estimates

**APPENDIX**

**Selected Tax Measures Enacted Since 1990  
Ranked by Dollar Value (\$ in Millions)**

	Enacted/ Amended	FY15	FY16
Personal Property Tax Relief Act ("Car Tax") -- 70% level for FY05 and part of FY06, \$950 million cap in FY07 and beyond	2004	(950.0)	(950.0)
Subtraction for those aged 65 or older and 62-64	1994	(405.5)	(417.7)
Add: Means testing of Age Subtraction	2004	116.4	126.0
Combined Age Subtraction		(289.1)	(291.7)
Sales Tax on Food -- Impose tax at 2.5 percent	2004	(537.9)	(556.2)
Estate Tax (SB504)	2006	(140.0)	(140.0)
Tax Credit for Land Preservation created 1999, ability to transfer 2002	2002	(100.0)	(100.0)
Tax Credit for Historic Rehabilitation - Individual, Corporate and Insurance	1999	(76.0)	(76.0)
Tax Credit for Families Below the Poverty Level	2000	(59.6)	(65.4)
Correct Low-Income Cliff Effect	2004	(65.4)	(54.6)
Combined Low-Income		(125.0)	(120.0)
Single Sale Factor Apportionment	2009	(58.9)	(58.6)
Coalfield Employment Enhancement Tax Credits & 2006 Allocation	2000	(34.2)	(34.2)
Increase Filing Thresholds & Personal Exemption increase	2004/2007	(32.2)	(32.2)
Increase Personal Exemption to \$930	2004/2007	(29.8)	(29.8)
Sales Tax Exemption for Non-prescription Drugs	1990	(36.5)	(38.7)
Increase Standard Deduction	2004	(21.3)	(21.3)
Subtraction for Military Wages -- Up to \$15,000	1999	(11.4)	(11.4)
Subtraction for Federal and State Employees -- Up to \$15,000	1999	(2.2)	(2.2)
Combined Low-Income Public Employee		(13.6)	(13.6)

	Enacted/ Amended	FY15	FY16
Subtraction for Unemployment Benefits	1999	(23.2)	(23.2)
Double Weighting of Sales Tax in Corporate Income Tax	1999	(15.0)	(15.0)
Neighborhood Assistance Tax Credit	97/06/12/14	(16.0)	(17.0)
Enterprise Zone -- General and Investment Tax Credits (now grants)	1998	(10.0)	(10.0)
Tuition tax credit (capped at \$25 million/year)	2012	(10.0)	(10.0)
Major Business Facility Job Tax Credit	1994/2010	(9.3)	(9.3)
Sales Tax Exemption for Economic Development (Data Centers)	2010/2011	(7.3)	(7.3)
Sales Tax Exemption -- For Profit Hospital Drug Samples	1999	(7.0)	(7.0)
Subtraction for Prepaid Tuition Plan; Deduction for Savings Trust	1998/2009	(7.0)	(7.0)
Tax Credit for Retaliatory Tax on Insurance Companies	1998/2011	(7.0)	(7.0)
Tax Credit for Motion Pictures	2010/2014	(6.5)	(6.5)
Create Admin Process for Registering Nonprofits	2003	(5.1)	(5.1)
Virginia Port Tax Incentive	2011	(4.0)	(3.0)
Refundable R&D Credit	2011/2014	(6.0)	(6.0)
Subtraction of Disability Income	2000	(4.0)	(4.0)
Tax Credit for Equity and Subordinated Debt Investments	1998/2012/2013	(4.5)	(5.0)
Interest Equalization	1999	(2.9)	(2.9)
Back to School Sales Tax holiday	2006	(2.8)	(2.8)
Sales Tax Exemption for Purchase of Internet Service Equipment	1999	(2.6)	(2.6)
Sales Tax Exemption -- Automobile Refinishing Materials	2005	(2.5)	(2.5)
Tax Credit for Green Jobs	2010/2011	(1.8)	(1.8)
Sales Tax Holiday Emergency Preparedness	2007	(1.7)	(1.7)
Subtraction for Income from Tobacco Settlement Payments	2000	(1.7)	(1.7)
Sales Tax Exemption for Optometrists & Medical Practitioners	1999	(1.6)	(1.6)
Tax Credit for Purchase of Equipment to Process Recyclable Materials	1998	(1.0)	(1.0)
Tax Credit for Telework	2011	(1.0)	(1.0)
Tax Credit for Taxes Paid to Other States (sale of capital asset addition)	1999	-	-

	Enacted/ Amended	FY15	FY16
<b>Actions with Minimal Impact (Less than \$1.0 million)</b>			
Tax Credit for Providing VHDA Low-Income Housing	1990	(0.2)	(0.2)
Tax Reduction for Providing Rent Reductions	1990	Minimal	Minimal
Tax Credit for Advanced Technology Pesticide & Fertilizer Equip.	1990	(0.1)	(0.1)
Subtraction for Qualified Research Expenses	1993	Minimal	Minimal
Tax Credit for Creating Jobs Involved in Clean Fuel Vehicles	1995	Minimal	Minimal
Tax Credit for Qualifying Steam Producers	1995	0	0
Tax Credit for Investment in Day Care Facilities	1996	Minimal	Minimal
Tax Credit for Agricultural Best Management Practices	1996	(0.5)	(0.5)
Tax Credit for Purchase of Vehicle Emission Equipment	1997	(0.1)	(0.1)
Subtraction for Qualified Agricultural Contributions	1998	Minimal	Minimal
Deduction for Contributions to Public School Construction Grants	1998	Minimal	Minimal
Tax Credit for Taxes Paid to a Foreign Country on Retirement Income	1998	(0.1)	(0.1)
Alt. Tax Credit for Purchase Mach/Equip. to Process Recyclable Mat.	1998	0	0
Tax Credit for Purchase of Waste Motor Oil Burning Equipment	1998	(0.1)	(0.1)
Tax Credit for Hiring TANF Recipients	1998	Minimal	Minimal
Sales Tax Exemption for Free Book Distribution	1998	(0.1)	(0.1)
Subtraction of Capital Gain for Land Dedicated to Open Space	1999	Minimal	Minimal
Deduction for Teacher Continuing Education Costs	1999	Minimal	Minimal
Tax Credit for Contributions to Political Candidates	1999	(0.4)	(0.4)
Tax Credit for Retrofitting Residence with Accessibility Features	1999	Minimal	Minimal
Tax Credit for Employing Persons with Disabilities	1999	Minimal	Minimal
Subtraction for Reparations from Nazi Persecution	2000	Minimal	Minimal
Subtraction for Income of Medal of Honor Recipients	2000	Minimal	Minimal
Virginia Coal Employment & Production Incentive Tax Credit	2000	-	-
Tax Credit for Riparian Buffers	2000	Minimal	Minimal

	Enacted/ Amended	FY15	FY16
Credit for Cigarettes Manufactured and Exported (n/a after 2010)	2004	0.0	0.0
Sales Tax Exemption -- Public Transportation	2005	(0.3)	(0.3)
Sales Tax Exemption -- Veterinary Meds	2006	(0.1)	(0.1)
Sales Tax Holiday Energy Efficiency	2007	(0.1)	(0.1)
Sales Tax Exemptions -- Economic Development Projects	2008	(0.9)	(0.9)
Provide Relief from Retaliatory Taxes	2010	(0.8)	(0.8)
Angel Investor Subtraction	2010	(0.5)	(0.5)
Virginia Winery and Vineyard Credit	2011	(0.2)	(0.2)
Tax Credit for Landlords Participating in Housing Choice Voucher	2013	(0.2)	(0.2)
<b>State Tax Reductions Enacted Since 1990</b>		<b>(2,551.7)</b>	<b>(2,570.4)</b>
 <b>Other State Tax Measures</b>			
Sales Tax Presence in Virginia Amazon	2012	19.5	21.5
Sales tax on satellite TV equipment	2014	9.6	9.6
Add 1/2 percent sales tax on non-food items	2004	485.6	500.2
Recordation Tax Rate Increase (net of 3 cents to transportation)	2004/2007	105.0	105.0
Tobacco Tax Increase	2004	142.4	142.4
Close Two Corp. Tax Loopholes/Eliminate ST Exemp for Public Svc. Co.	2004	143.1	143.1
<b>Other State Tax Measures</b>		<b>905.2</b>	<b>921.8</b>
<b>Net State Tax Actions</b>		<b>(1,646.5)</b>	<b>(1,648.6)</b>

Note: Estimates reflect initial impact statements updated for actual and forecast data