2016 Session

Revenue and Budget Outlook

November 19, 2015

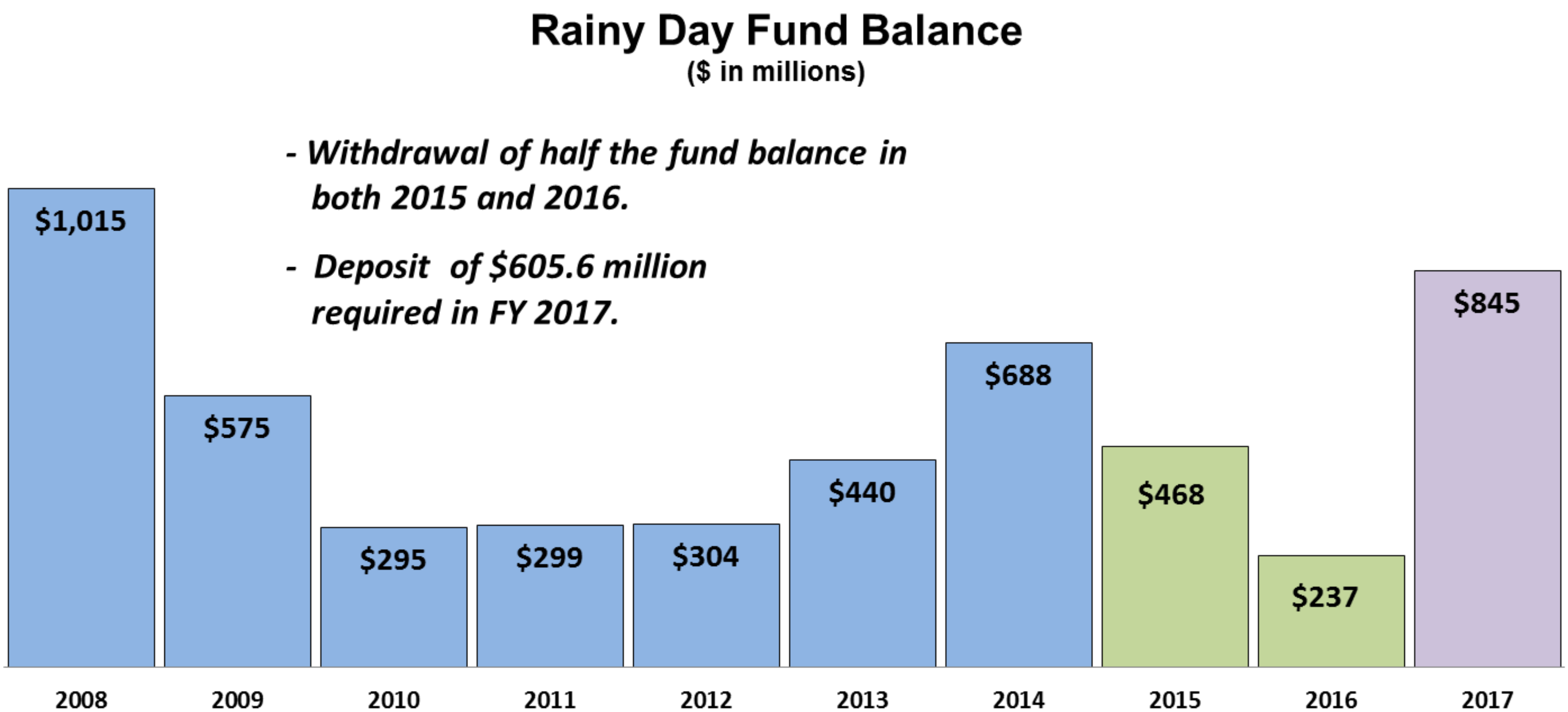
Outlook for the 2016 Session

- FY 2015 actual revenues above forecast; revenues through first quarter of FY 2016 exceed the forecast.
  - Strength should continue in FY 2017 and FY 2018.
- Virginia's economy still underperforming the nation.
  - Bright spots in the economy: NOVA jobs, housing, consumer spending.
  - Growth rates projected for the next biennium (3.6 percent in FY 17 and 3.8 percent in FY 18) will remain below long-term trend of 5.5 percent.
- Good news: budget is structurally balanced – no major "holes" to fill; efforts to pre-pay funding obligations paying off.
- Projected resources should be sufficient to fund base budget, plus mandated and high priority spending items.
- Even with budget deal at federal level, cautious approach to the budget recommended given volatility in the environment.

A Tale of Two Sessions

- Spent most of 2014 dealing with a $438 million budget shortfall in FY 2014, and the repercussions for FY 2015 and 2016 ($2.0 billion).
  - FY 2014 revenues dropped 1.6 percent.
  - $705 million of the shortfall addressed by two withdrawals from the Rainy Day Fund; balance from budget cuts and resource actions.
- 2015 Session was far easier -- recouped about $624 million in resources in the amended budget adopted in April of this year.
  - Maintained a conservative revenue forecast for FY 2015 and FY 2016, given the recent volatility.
- FY 2015 produced a revenue surplus of about $550 million -- mostly from non-withholding, some from payroll withholding.
  - FY 2015 revenues grew 8.1 percent, up from the forecast 4.7 percent.
  - Most of the surplus designated for a required Rainy Day Fund deposit – not programmed into spending.

Rebuilding the Rainy Day Fund



2015 Session Key Actions
Budgeting in an era of uncertainty

- **Reinforced "structural balance" in the budget.**
  - Used much of the unanticipated revenue growth for one-time uses.
    - Set-aside $129.5 million for FY 2017 Rainy Day Fund deposit.
    - $141.4 million for GF capital projects, rather than using bonded debt.
  - Unwound "gimmicks" used to address budget shortfall.
    - Eliminated the $30 million Aid to Localities reversion.
  - ***Actions help maintain Virginia's "triple-triple A" bond ratings.***

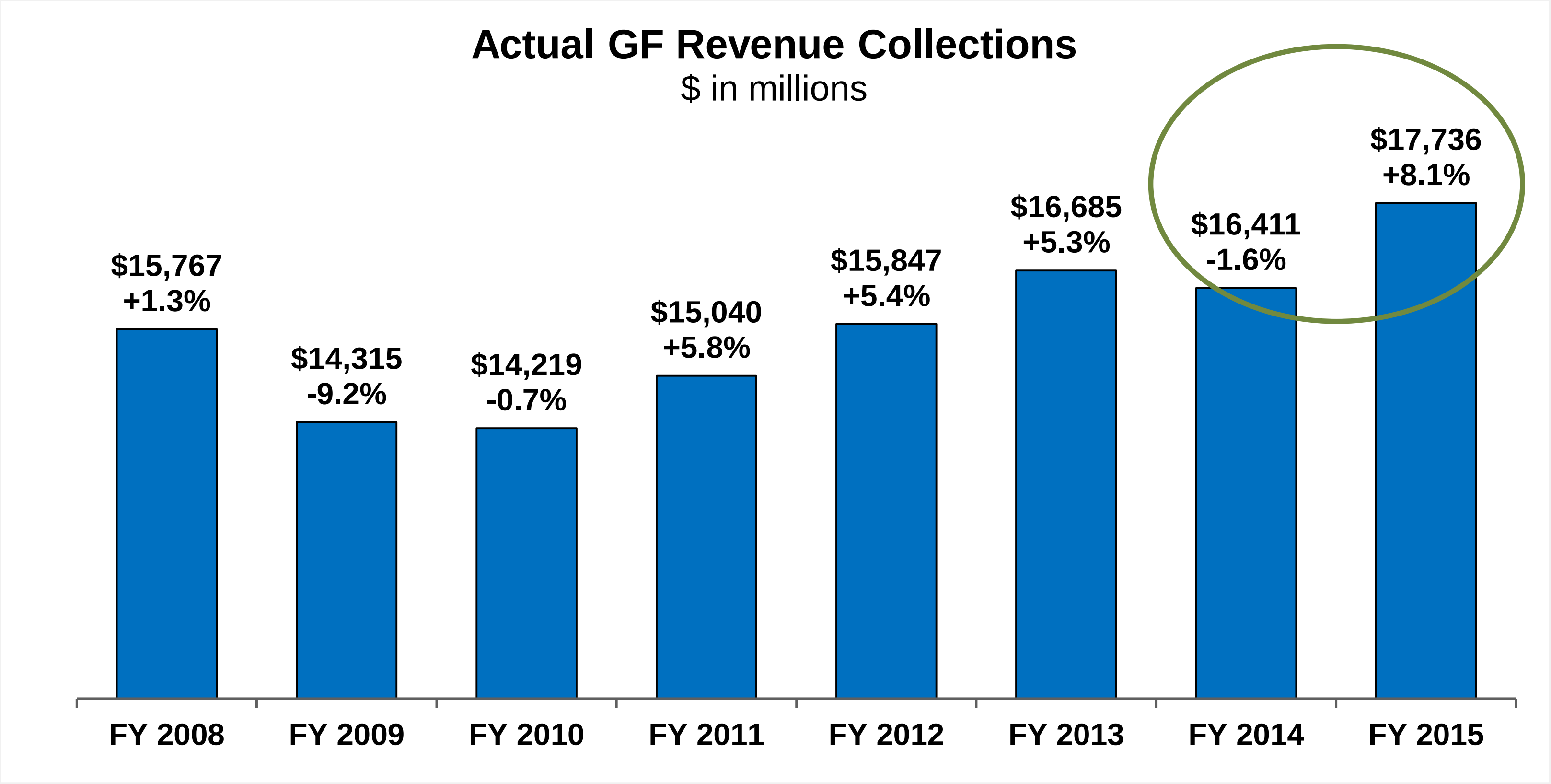
- **Pre-payment of scheduled VRS obligations.**
  - **Teachers:** One-time payment of $192.9 million NGF (from Literary Fund unclaimed property) to address unfunded liability for teachers. Lowered the balance on the 10-year repayment of the contribution amount deferred during the 2010 Session.
  - **Other Employee Group Plans:** $32.3 million GF to <u>increase</u> the employer contribution rates for the other plans up to 90 percent of the Board rates in FY 2016, ahead of the scheduled phase-in.

Economic Outlook for the 2016 Session

- Virginia's economy is gaining momentum, although statewide growth is still underperforming the nation -- not surprising given Virginia's heavy dependence on federal spending – but the growth gap is shrinking.
- Virginia's economy has stabilized after the "sequestration slump," and is growing, with Northern Virginia driving job growth.
- The housing market is gaining ground.
- Consumer spending is being fueled by low gas prices and rising wages.
- Even so, Virginia's revenue growth rates will remain subdued as we move through the "mature" stage of the economic expansion.

Looking Back:
FY 2015 Revenue Performance

- GF revenue grew 8.1 percent, compared to a decline of 1.6 percent for FY 2014.



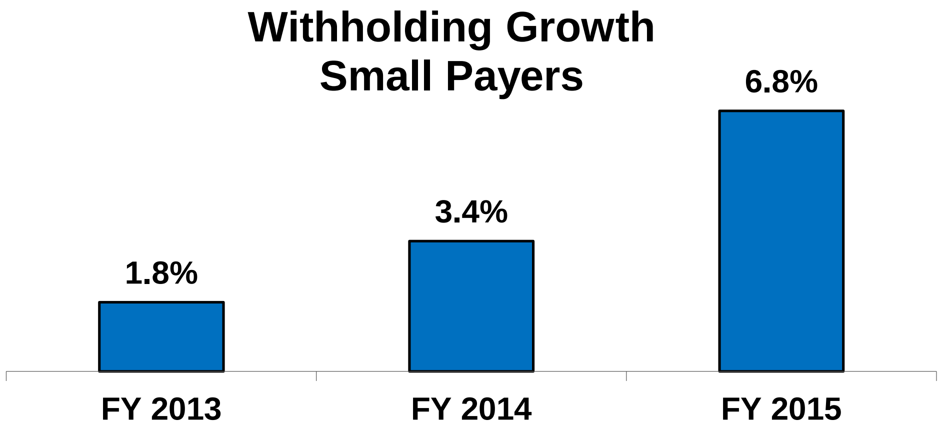
FY 2015 Collections Over Forecast

- FY 2015 actual GF revenues exceeded the forecast by $549.6 million.
  - Over 90 percent of this amount came from strong payroll growth (both withholding and nonwithholding).
  - The entire "surplus" is committed to the Rainy Day Fund and the Water Quality Improvement Fund (WQIF Part A = $55 million; Part B = $6.7 million).

GF Revenue Source	Percent of GF	Forecast Growth	Actual Growth	Variance ($ in millions)
Withholding	63%	4.0%	5.3%	$140.4
Non-withholding	16%	7.9%	20.5%	316.4
Refunds	(11)%	3.2%	0.1%	55.5
Sales Tax	19%	4.9%	5.5%	17.6
Corporate Income Tax	5%	11.0%	9.8%	(9.0)
Recordation	2%	2.4%	11.4%	28.0
Insurance	2%	0.0%	(6.2)%	(19.9)
All other	4%	(4.4)%	(1.5)%	20.5
Total All	**100%**	**4.7%**	**8.1%**	**$549.6**

FY 2015 Collections Over Forecast

- The non-withholding “surplus” occurred largely because this source was capped in the revenue model (10-year average of non-withholding as percent of total collections) to hedge against recent volatility in spring final payments.
  - Resulting “surplus” was earmarked to help fund the anticipated FY 2017 Rainy Day Fund deposit of $605.6 million.
  - Going forward, such a cap would be questionable since no FY 2018 Rainy Day Fund deposit is expected at this time.
- Small business job growth has been stronger than expected.



FY 2016 First Quarter Performance

- First quarter performance was better than expected -- collections grew 2.4 percent in Q1 against (0.1) percent required to meet the revised estimate.
  - Adjusting for the Accelerated Sales Tax program, **total revenues rose 4.0 percent**, ahead of the forecast.
    - Net individual income tax (69% of general fund revenues) grew 5.5 percent, ahead of the revised estimate of a 0.9 percent decline.

GF Revenue Source	% of GF	% Growth Thru Sep	Required for Forecast
Withholding	64%	4.4%	2.1%
Non-withholding	16%	10.3%	(8.4%)
Refunds	(10)%	(0.5%)	4.7%
Net Individual	**69%**	**5.5%**	**(0.9%)**
Sales	19%	(5.1%)	2.7%
Corporate	5%	(17.0%)	(1.3%)
Wills (Recordation)	2%	9.7%	(8.1%)
Insurance	2%	n/a	8.7%
All Other	3%	1.6%	2.8%
Total	**100%**	**2.4%**	**(0.1%)**
Sales w/o AST & HB 2313		4.5%	2.7%
Total w/o AST & HB 2313		**4.0%**	**0.0%**

Fiscal Year 2016 Outlook

- Forecast of economic variables that drive individual income taxes was revised upward since Fall of 2014.
- Economic variable that predicts sales tax growth, personal income, is unchanged.

Updated Economic Variables

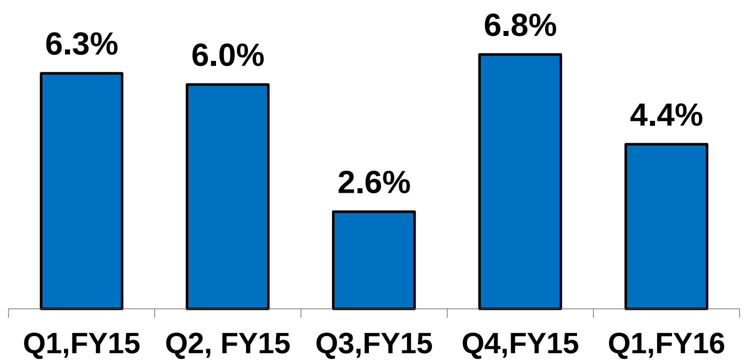
	Job Growth	Avg Wage/ Salary Growth	Jobs + Avg Wage/ Salary Growth	Proprietor's Income Growth	Dividends, Int. & Rent Growth	S&P 500 Prior CY Growth	Total Personal Income Growth
Official (Nov 2014)	1.4%	2.0%	3.5%	0.7%	4.5%	5.8%	3.8%
IHS Standard (Sep 2015)	**1.5%**	**2.6%**	**4.1%**	**3.8%**	**4.4%**	**6.5%**	**3.8%**

FY 2016 First Quarter Performance

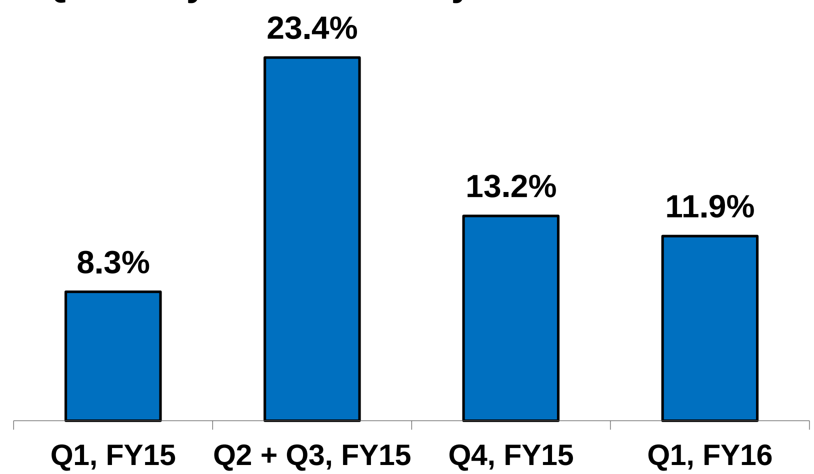
What the combined economics and "money in the bank" tell us:

- **Net individual income tax** collections grew 5.5 percent, confirming the updated economic forecast that predicts stronger growth than expected in Fall 2014.

Quarterly Withholding Growth



Quarterly Estimated Payment Growth

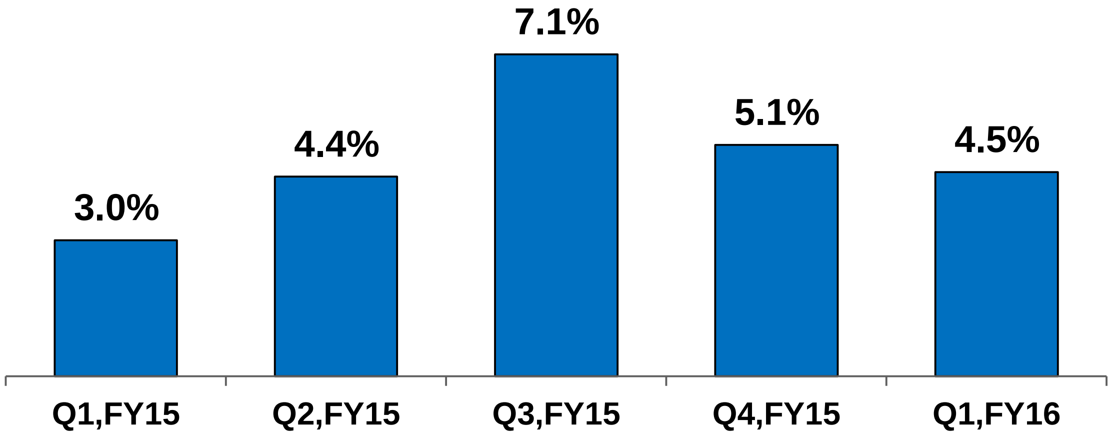


- Growth rates should migrate down as the year progresses, but will remain solid.

FY 2016 First Quarter Performance

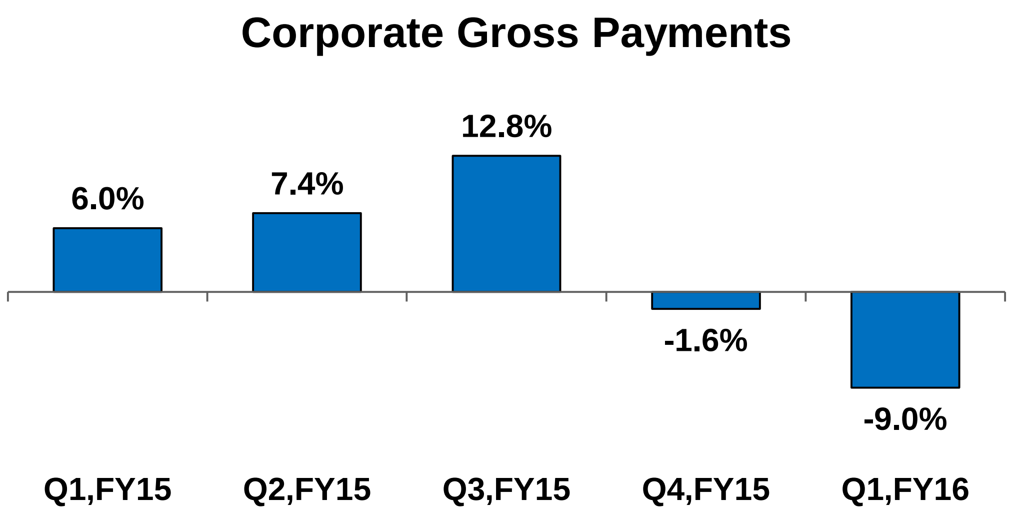
- **Sales tax** growth of 4.5 percent (adjusted for accelerated sales tax to reflect economic growth) suggests that lower gas prices and housing activity are adding more strength than expected in Fall 2014.
  - But, when projected FY 2016 growth is compared to actual collections last year, the growth rate will be artificially depressed because several AST policy changes pulled extra dollars into FY 2015.

Quarterly Economic Sales Tax Growth



FY 2016 First Quarter Performance

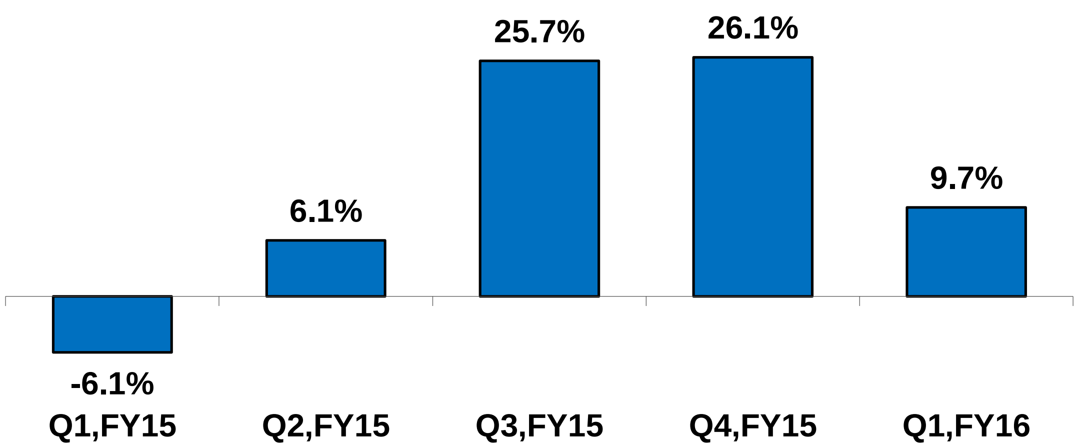
- **Corporate** estimated payments declined 9.0 percent based on a few large corporations reducing their September payments.
  - There may be some impact from a recent tax policy change allowing manufacturing corporations to apportion tax liability solely on the basis of sales (single sales factor).
  - Will have clearer picture after Q2 corporate refunds are known.
  - Corporate growth rate should be reduced.



FY 2016 First Quarter Performance

- **Recordation tax** growth of 9.7 percent signals continued housing market strength, although the rate of growth should decline by year end.
- New homes sales are contributing more to growth.
  - According to the Federal Reserve Bank of Richmond, Virginia housing starts increased in July and August by 25.8 percent and 53.8 percent respectively.

Quarterly Recordation Tax Growth



FY 2016 Revised Forecast

- SFC staff estimate for FY 2016 GF revenue growth is 4.1 percent, versus 3.1 percent assumed in the Official forecast, producing **$746.1 million** in additional revenue.
  - Updates to the Transfer forecast will provide another **$29.1 million**.
  - About $211 million of the additional revenue will be needed to fund budget pressures in FY 2016 (the "Caboose Bill").

Revenue Source ($ in millions)	Forecast % Growth	$ Above Official
Withholding	4.0%	$211.0
Non-withholding	7.0%	469.7
Refunds	1.0%	65.8
Sales	3.2%	17.0
Corporate	**(11.8%)**	**(86.6)**
Recordation	6.1%	49.1
Insurance	10.2%	4.4
All Other	5.1%	15.7
Total GF Revenue Growth	**4.1%**	**$746.1**

Virginia's Revenue Outlook: Turning to the 2016-18 Biennium

- Virginia will continue to underperform the nation, but the gap will be one-third of what it was in FY 2015.
- Employment continues to grow modestly, driven mainly by gains in Northern Virginia.
  - Rate of job growth will slow by end of the biennium, but wage/salary growth more than compensates.
  - Rebound in high-paying Professional and Business Services jobs contributes to higher wages and salaries.
- Homebuilding and existing home sales will continue to be a stimulus.
- Consumer spending will continue to improve with higher disposable income.
  - Gasoline prices are expected to stay low for the near term, pushing sales to goods that generate GF sales tax.
  - Increase in net worth, particularly housing value, encourages consumer spending.
- Exports will likely be a drag on the economy.

Virginia's Revenue Outlook: Turning to the 2016-18 Biennium

- The updated economic forecast is similar to FY 2016, with changes at the margin:
  - Slightly higher withholding growth;
  - Lower non-withholding growth in FY 2017;
  - Slightly higher sales tax growth.

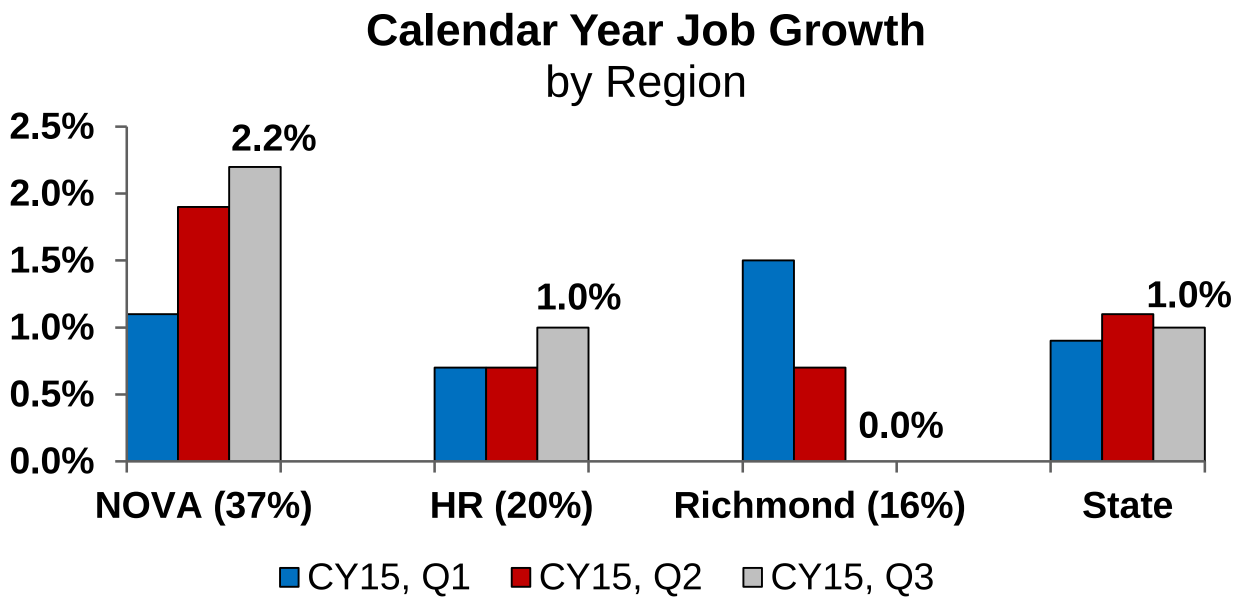
Projected Economic Variables

IHS Global Insight National Forecast, adjusted for Virginia specific data

	Job Growth	Avg Wage/ Salary Growth	Jobs + Avg Wage/ Salary Growth	Proprietor's Income Growth	Dividends, Int. & Rent Growth	S&P 500 Prior CY Growth	Total Personal Income Growth
IHS Standard (Sep 2015)							
FY 2016	1.5%	2.6%	4.1%	3.8%	4.4%	6.5%	3.8%
FY 2017	1.4%	3.1%	4.5%	2.2%	4.3%	1.8%	4.3%
FY 2018	1.1%	3.1%	4.2%	3.6%	6.4%	5.8%	4.5%

Factors Driving the 2016-18 Outlook

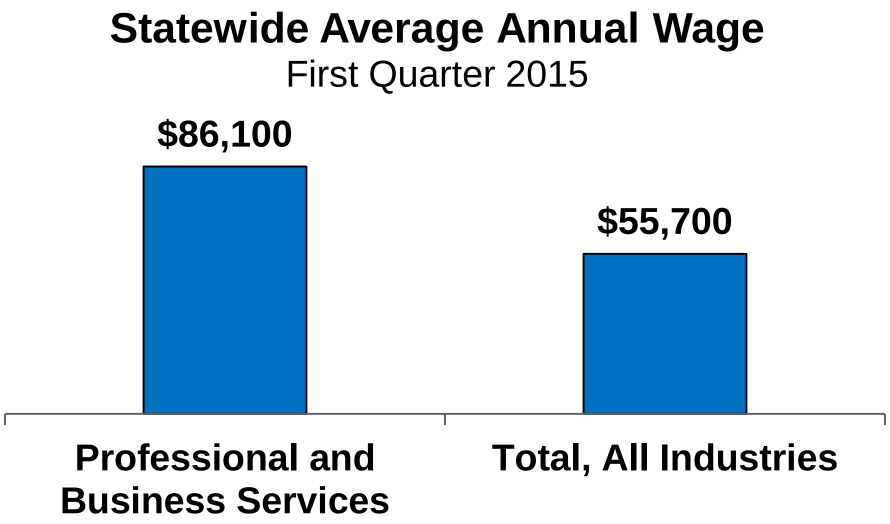
- Employment growth has recovered from the "sequestration slump" largely due to NOVA's strong performance (37 percent of Virginia's jobs).



- Growth for the Richmond region has decelerated and was flat for Q3.

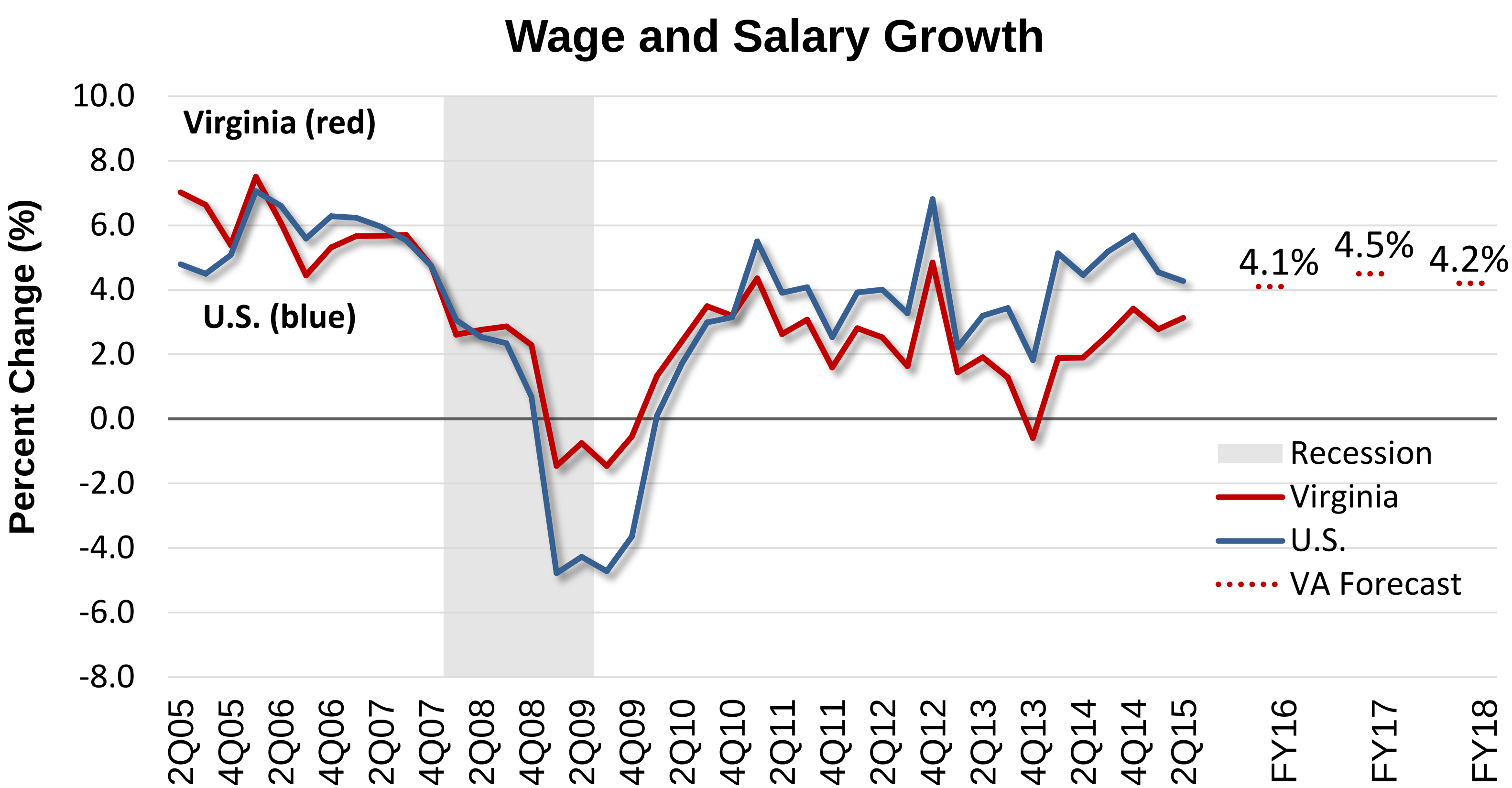
Factors Driving the 2016-18 Outlook

- The rate of overall job growth will slow slightly in the next biennium; however, that will be more than offset by the higher wage/salary growth that accrues from the changing mix of jobs.
- The dramatic reversal this year in growth of NOVA Professional and Business Services jobs, going from 0.1 percent growth in January to 1.7 percent growth in September, sets the stage for a shift back toward higher paying jobs.



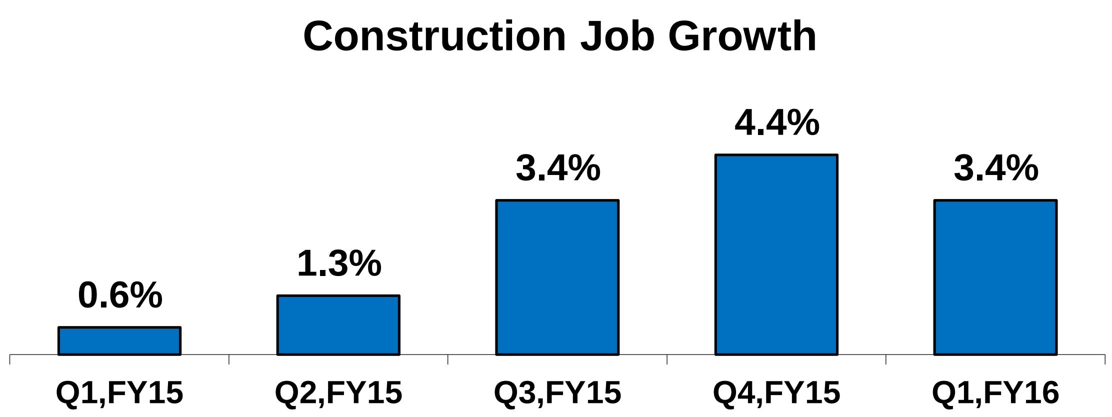
Factors Driving the 2016-18 Outlook

- Wages and salaries are expected to grow by more than 4 percent each year through the next biennium.



Factors Driving the 2016-18 Outlook

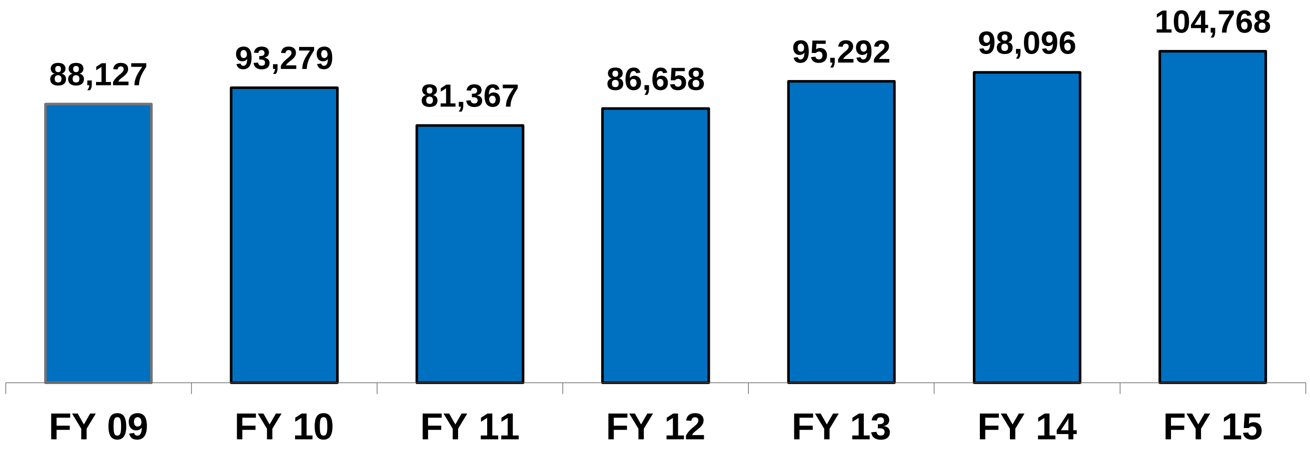
- Homebuilding and existing home sales will continue to be a stimulus as credit availability improves and demand from young adults strengthens.
- Housing construction generally is a key component of an economic recovery, but has not been a factor during the current one. This trend may be changing:
  - Loan originations have shifted from mostly refinancings to mortgage loans (Virginia refinance originations dropped 25.8% in 2013 and 60% in 2014).
  - Construction jobs now are a contributor to growth in Virginia.



Factors Driving the 2016-18 Outlook

- New and existing home sales are rising; growth in first quarter of FY 2016 was 11.3 percent over the prior year quarter.
- Current sales remain below the 140,000 range of ten years ago; unlikely to see a return to that level, but there is pent up demand and room for growth.

New and Existing Home Sales
Virginia Association of Realtors



Factors Driving the 2016-18 Outlook

- Exports likely will not contribute significantly to Virginia's economic performance.

- Virginia's reliance on exports is somewhat different than the nation's.
  - Per the Virginia Chamber of Commerce International Trade Profile:
    - Exports are 8 percent of Virginia's economy versus 12 percent for the nation.
    - Half of Virginia's exports are service-oriented versus 34 percent for the nation.

- Virginia is actively pursuing the strategy of increasing exports as a way to diversify its economy away from high dependence on federal spending.
  - Mid-size businesses in trade sectors (those with 20-499 workers) have been targeted for increased export activity.
  - Virginia has about 6,500 such firms that offer a large pool of potential exports.
  - Unique characteristics of Virginia's export activity and recent focus on mid-size exporters may lessen the drag.

SFC Staff GF Revenue Estimate

($ in millions)	FY 2016	FY 2017	FY 2018
SFC GF Revenue Estimate	**$18,466.8**	**$19,127.4**	**$19,864.0**
<u>Growth by Revenue Source</u>			
Withholding	4.0%	4.2%	4.2%
Non-withholding	7.0%	2.5%	5.1%
Refunds	1.0%	3.3%	4.8%
Sales	3.2%	3.6%	3.7%
Corporate	(11.8%)	4.2%	(1.7%)
Recordation	6.1%	4.2%	4.0%
Insurance	10.2%	7.0%	4.6%
All Other	5.1%	(4.7%)	0.9%
Total GF Revenue Growth	**4.1%**	**3.6%**	**3.8%**
SFC Transfer Estimate	**$593.6**	**$604.8**	**$624.6**
Total GF Resources	**$19,060.4**	**$19,732.2**	**$20,488.6**
Revenues above Chapter 665	**$746.1**		
Transfers above Chapter 665	**$29.1**		

Final Observations on Revenues

- Virginia's economy continues to improve and will grow at a moderate pace as the economic expansion matures (in the 6th year of the expansion).
  - Some upside potential may accrue now that uncertainty about the federal budget has been removed.
  - Conversely, conditions in the international economy could impact the U.S. more than expected.
    - But, softening that might occur at the national level wouldn't have an immediate impact on the state economy.

- Now that stability has returned in Virginia, the Rainy Day Fund, which will reach about $845 million in FY 2017, should provide sufficient protection against uncertainty.

Consensus Revenue Forecasting Process

- **Joint Advisory Board of Economists (JABE) -- met in mid-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 November 30th.**
  - Cross-section of leaders from Virginia business and industry, General Assembly leadership.
  - Members review 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.

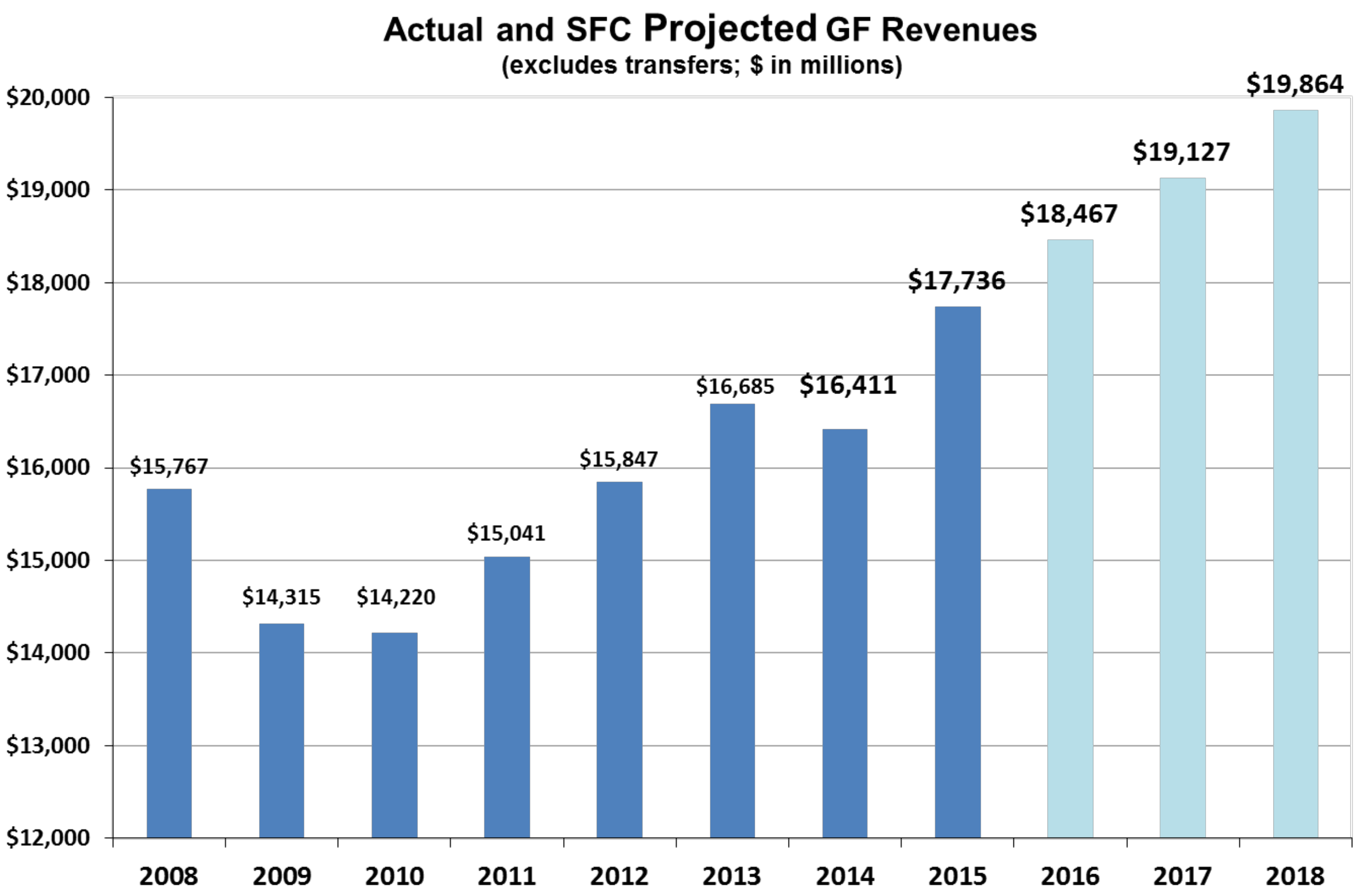
Developing the 2016-18 Budget
Calculating the Base Budget

- **Base budget** = cost of maintaining **current** services and caseloads.
- **One-time** spending items are **deducted** from the FY 2016 appropriation (capital outlay, seed money).
- On-going items that are **not fully funded** in FY 2016 are **added** to the base (partial-year salary increase).

2016-18 GF Base Budget Calculation
($ in millions)

Ch. 665, FY 2016 GF Approp. x 2	**$37,528.3**
Minus: One-time Spending	($429.2)
Plus: Technical Adjustments	$21.0
Total, Adjustments to Base	**($408.2)**
SFC Biennial (Two-Year) GF Base	**$37,120.1**

Actual and SFC Projected GF Revenues



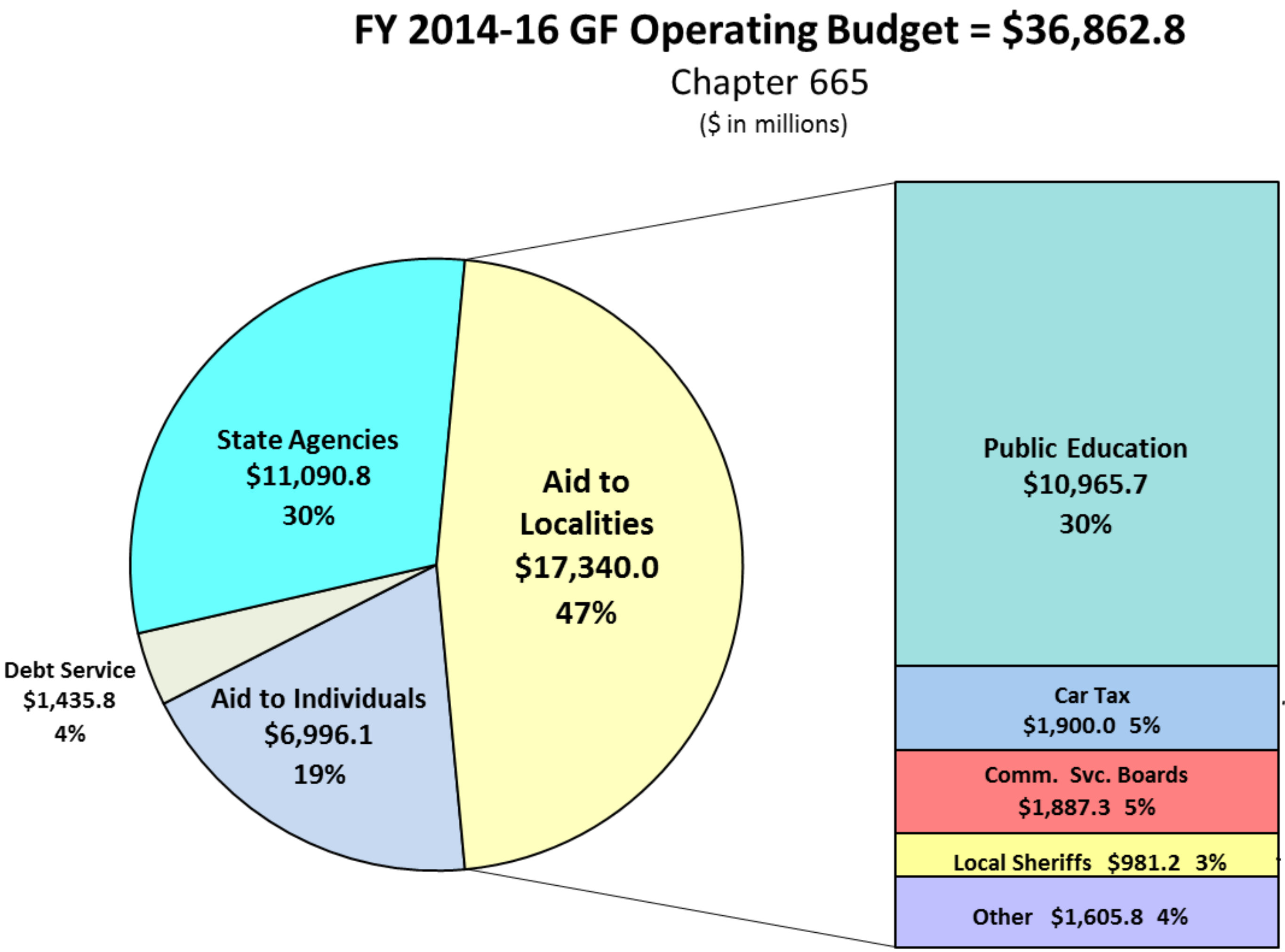
Developing the 2016-18 Budget

Comparing projected resources to the current base budget.

($ in millions)	FY 2017	FY 2018	2016-18
Revenue Growth Rates	**3.6%**	**3.8%**	
SFC Staff Forecast	$19,127.4	$19,864.0	$38,991.4
Transfers	604.8	624.6	1,229.4
Total GF Resources	**$19,732.2**	**$20,488.6**	**$40,220.8**
SFC GF Base Budget	$18,565.2	$18,555.0	$37,120.1
Resources Above Base	**$1,167.0**	**$1,933.6**	**$3,100.7**
Balance Forward*	**$587.8**		

- FY 2016 additional revenue net of required spending, plus FY 2015 available agency balances.

General Fund Budget Drivers

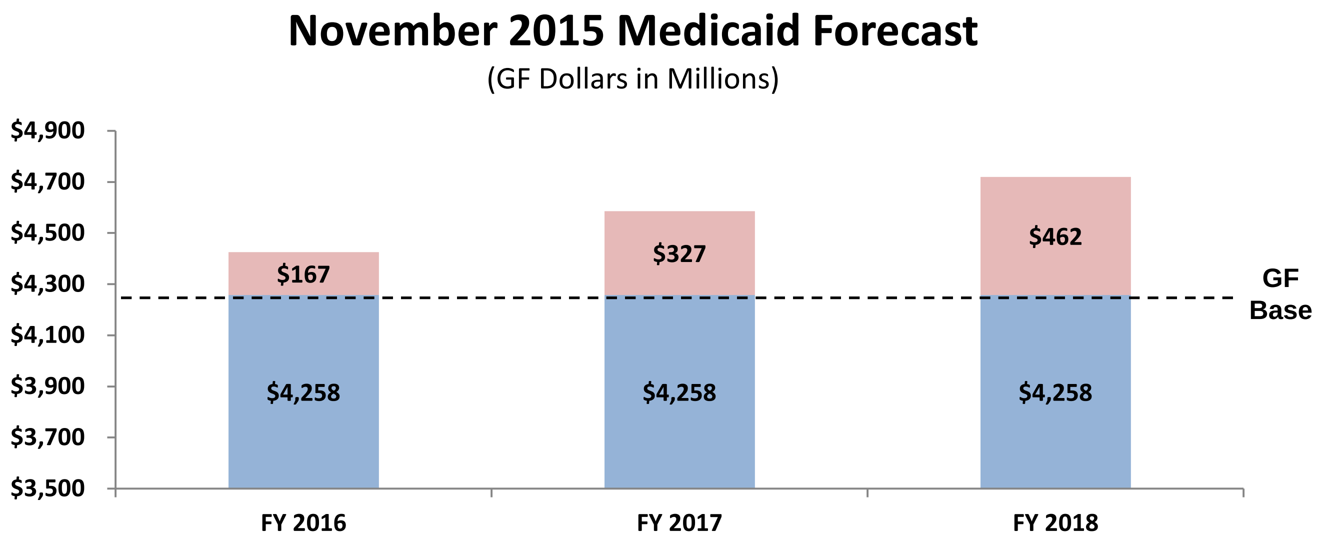


2016-18 Budget Pressures

($ in millions)	FY 2016	FY 2017	FY 2018	FY 2016-18
Medicaid Utilization & Inflation	$166.6	$327.4	$461.7	**$789.1**
DoJ Settlement - Waiver Redesign	0.0	22.6	34.4	**57.0**
DoJ Settlement - Waiver Slots	0.0	15.3	31.9	**47.2**
DoJ Settlement - Related Compliance	0.0	16.0	15.1	**31.1**
DoJ Settlement - Facility Closure Costs	7.3	0.0	0.0	**0.0**
Children's Svcs. (CSA) Utilization Increase	16.4	16.4	16.4	**32.8**
DBHDS Geriatric Facilities	8.4	13.1	5.9	**19.0**
Dept. Social Svcs. Child Welfare Costs	0.0	6.0	8.0	**14.0**
HHR Agencies IT Costs	0.0	10.1	11.7	**21.8**
K-12 Rebenchmarking	0.0	178.7	209.1	**387.8**
K-12 Composite Index	0.0	25.2	25.4	**50.6**
K-12 VRS, Group, Retiree HCC	0.0	19.3	19.4	**38.7**
Employee Health Insurance	0.0	40.1	85.7	**125.8**
Debt Service	0.0	51.4	56.8	**108.2**
DOC Re-open Culpeper for Women	0.2	18.4	22.5	**40.9**
DOC Inmate Medical/Health Records	1.2	9.3	13.5	**22.8**
State Police IT, VITA Costs	0.0	13.1	5.6	**18.7**
Comp Board Jail per diems	11.3	10.4	11.1	**21.5**
Higher Ed New Facilities Coming On-Line	0.0	12.5	15.3	**27.8**
Agency IT Costs (VITA, Cardinal)	0.0	12.9	13.5	**26.4**
Total	**$211.4**	**$818.2**	**$1,063.0**	**$1,881.2**

Medicaid Forecast

- Additional funding of $167 million GF in FY 2016 and $789 million GF for fiscal years 2017 and 2018 is required to address caseload and cost growth. Slow growth in spending is projected to continue with increases of 3.8% in FY 2017 and 2.9% in FY 2018.
  - FY 2016 reflects a need due to $74 million in payments delayed from FY 2015.
  - The FY 2015 shortfall was due to higher than expected enrollment of low-income parents (the cost impact ripples across all three years).



VRS Rates Ahead of Phased-In Schedule for Three of Five Plans

- Because of the advancing of the rates for FY 2016, the base budget rates are actually **ahead** of the six-year scheduled phase-in of board approved rates adopted in the 2012 VRS reform legislation.
  - Costs of approx. $25 million in FY 2017 and 2018 for teachers and VALORS.
  - *Potential savings of $27.5 million per year if original schedule maintained for other groups. No additional budget cost to stay ahead of the schedule.*

	FY 2016 Funded Rate (beg. in Sept.)	2015 Funded Status (Actuarial)	Board Approved Full Rate, 2016-18*	2016-18 Scheduled Phase-In %	Phased-In Rate	FY 16 Base Budget Rate as % of 2016-18 Full Rate	Cost/(Savings) to Adjust Back to Schedule
Teachers	14.1%	69.2%	16.3%	**90%**	14.7%	**86%**	**$20M**
VaLORS	19.0%	60.6%	22.2%	**92%**	20.4%	**86%**	**$5M**
State	14.2%	71.2%	14.5%	**89%**	12.9%	***98%***	***($22M)***
SPORS	27.8%	67.7%	29.0%	**92%**	26.7%	***96%***	***($1M)***
Judicial	50.0%	73.7%	45.2%	**95%**	42.7%	***110%***	***($4.5M)***

*Approximately 2/3 of the rates are due to amortizing the unfunded liability.

Other Potential Funding Items

- **Salary Increase** – 1 percent increase for classified state employees and state-supported locals = $32.4 million GF per year.
- **Teacher Salary Increase** – 1 percent increase = $41.6 million GF per year.
- **Faculty Salary Increase** – 1 percent increase = $19.3 million GF per year.
- **Financial Aid for Colleges and Universities -** $24.1 million GF the first year and $32.1 million GF the second year to maintain **current** level of aid.
- **Maintenance Reserve** – Funding of roughly $75 to $85 million per year has been provided in recent years; could fund with debt.
- **Equipment for New Facilities Coming on Line** – About $22 million; could fund with debt.
- **Economic Development/Research Initiatives** – Funding for efforts to diversify Virginia's economy - TBD.
- **Education Initiatives** – Funding for K-12 and higher education – TBD.

Developing the 2016-18 Budget

- Resources should be available to fund mandated and high priority spending items, along with other traditional priority spending items (e.g. salary increases, financial aid, etc.)

($ in millions)	FY 2017	FY 2018	2016-18
Total GF Resources	**$19,732.2**	**$20,488.6**	**$40,220.8**
SFC GF Base Budget	$18,565.2	$18,555.0	$37,120.1
Resources Above Base	**$1,167.0**	**$1,933.6**	**$3,100.7**
Less:			
Mandated/High Priority	$818.2	$1,063.0	$1,881.2
Available Resources	**$348.8**	**$870.6**	**$1,219.4**
Other Priority Spending (est)	$325.0	$525.0	$850.0

Challenges of the 2016 Session

- Virginia's budget outlook is positive:
  - Economic outlook for the remainder of the current fiscal year and the next biennium is sound, with growth rates between 3 and 4 percent.
  - Revenues will be sufficient to cover the base budget, address mandated and high priority spending items, with resources left over to address selected priority items or investments.

- Deal on the federal budget simply pushes the "pause" button, but does not eliminate the reality of future reductions in defense and other federal spending that drives jobs.
  - Investments in efforts to diversify Virginia's economy should be an area of focus.
  - Continue to address current long-term funding obligations.
  - Keep budget structurally balanced and maintain flexibility.