2007 Session Budget and Economic Outlook

- **Highlights of the 2006-08 budget.**
  - How were additional resources allocated?
- **Budget outlook for 2007 Session.**
  - What are the short-session budget pressures?
- **Economic and revenue outlook for remainder of 2006-08 biennium.**
  - Based on FY 2006 actual performance, what changes can we expect for this year and next?
- **Looking ahead to the 2008-10 biennium.**
  - How will actions taken this session impact the next biennial budget?

The budget outlook prior to the 2006 Session…

- Last year at this time, SFC staff estimated that significant resources would be available for the 2006 Session, based on FY 2005 collections.

- Economy was strong -- revenue growth for the remainder of FY 2006 and the 2006-08 biennium was projected to be healthy, although growth was projected to slow.

  - Revenue growth in two of the three volatile sources -- corporate and withholding -- was expected to stay in positive territory.

  - Revenue growth in the third volatile source -- recordation taxes -- was projected to decline in both years.

- Based on the budget as adopted, revenue growth above the 2004-06 "base" was projected to be about **$4.5 billion** for the 2006-08 biennium.

- In addition, a fiscal year 2006 surplus of about **$1.5 billion** was anticipated and incorporated into the 2006-08 budget.

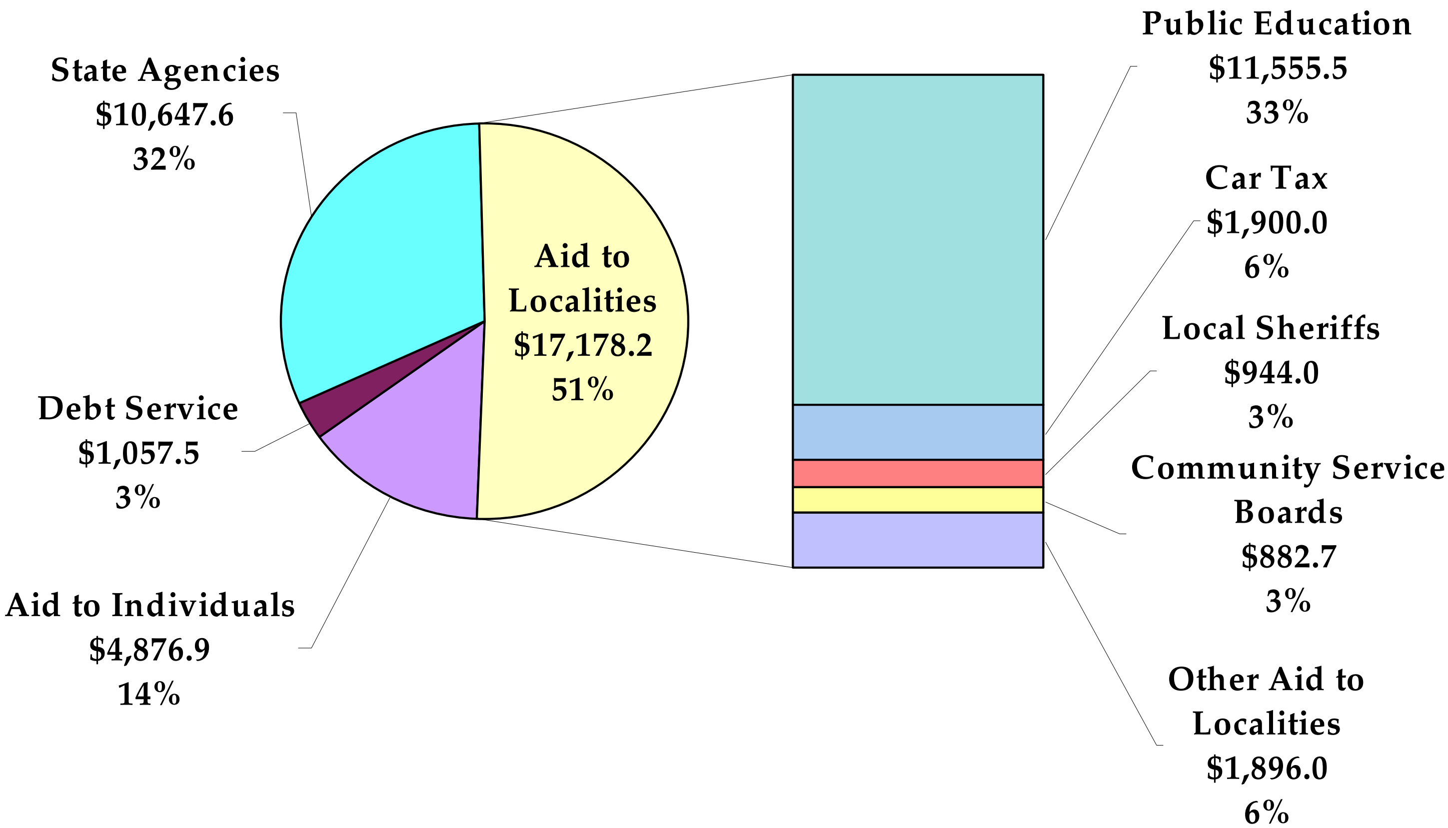
How were these additional resources used?

- Adopted tax policy changes.
- Funded mandated or high priority issues.
- Continued to make investments in selected areas.
- Directed anticipated revenue surplus to one-time uses.

General fund budget drivers

- *Over one-half of the general fund operating budget supports local programs.*
  - *The largest share goes to public education, at 33 percent of the total GF operating budget.*

2006-2008 GF Operating Budget
$33,761.5 million



(Detail provided in Appendix I).

How the resources were used…

- ✓ **Adopted tax policy changes – fiscal impact of about $160 million per year.**

  - Estate tax;
  - Land preservation tax credit;
  - Elimination of remaining portion of requirement for retailers to pay accelerated June sales tax;
  - Other actions: coal tax credit, long-term health care credit, neighborhood assistance act, sales tax holiday.

- ✓ **Provided about $2.5 billion for mandated or high-priority items, including:**

  - $1,316 million to re-benchmark the SOQ;
  - $484 million for Medicaid utilization and inflation;
  - $149 million for employee benefit cost increases;
  - $138 million for an additional deposit to the Rainy Day Fund;
  - $122 million to operate new prisons;
  - $113 million for increased debt service payments;
  - $77 million for CSA and adoption subsidies.

How the resources were used…

✓ **Continued to make investments in areas with long-standing commitments. Highlights include:**

- Provided $237 million for continued improvement on higher education "base adequacy", plus $70 million for a research initiative.

- Funded $277 million for salary increases in both years for state employees and state supported locals, and $61 million for faculty salaries (4 percent first year; 3 percent second year).

- Directed $229 to FRANS debt service for transportation;

- Added $207 million for teacher salary increases (4 percent first year; 1.5 percent second year reserve).

- Initiated mental health/mental retardation restructuring with funding of $126 million.

✓ **Directed anticipated revenue surplus to one-time uses.**

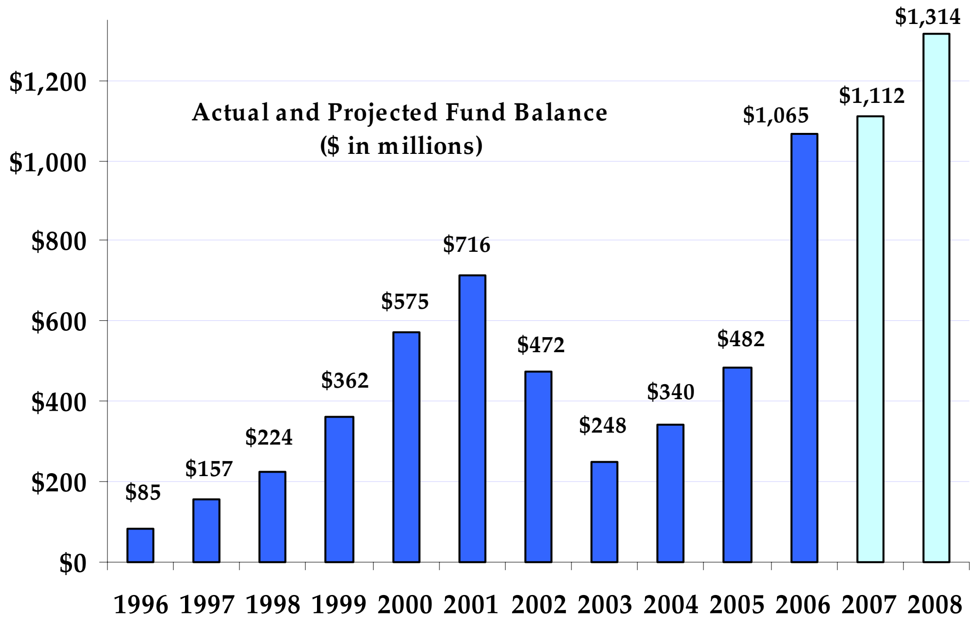
- Funded a major capital outlay program with $1,021 million in general fund cash.

- Set aside $200 million for Water Quality Improvement initiatives.

- And, earmarked $339 million for a one-time contingent appropriation for transportation.

Are we maintaining "structural balance?"

✓ Continuing to rebuild the Rainy Day Fund.



✓ Matching revenues and appropriations year-to-year, without relying on year-end balances.

✓ Budgeting costs in each year of the biennium, rather than leaving second-year "holes".

✓ Providing salary increases for state-supported employees in **both** years of the biennium.

✓ Directing surpluses and one-time revenues to non-recurring expenditures, such as capital outlay or water quality initiatives.

Budget pressures for the 2007 Session.

- The 2007 short-session budget adjustments for mandated or high priority items are modest, since the 2006-08 budget contained few second-year "holes", and the session ran long.

- Shortfalls of about $127 million in Health and Human resources programs include TANF (federal welfare reform changes), Comprehensive Services Act, adoption, and foster care services.

  - Medicaid programs, overall, will likely require little new funding, with the exception of FAMIS and S-CHIP health insurance for low income children (about $8 million).

  - Lower tobacco tax and Master Settlement revenues create a shortfall of at least $24 million in the Virginia Health Care Fund.

- Public safety items include almost $20 million to fund basic operations of adult and juvenile corrections, and $13 million for court-appointed attorneys' fees.

- Other funding includes $20 million for jail per diems, and about $9 million for a projected 2.5 percent increase in employee health insurance costs.

- **Nonetheless, expectations are high – over $1.5 billion in budget requests from agencies.**

Mandated or high-priority funding items

Preliminary Funding Items	Bien. GF
Rainy Day Fund – recalculation of cap	$6.5
Water Quality Imp. Fund – FY 06 rev/balances	$5.1
Health and Human Resources:	
TANF Changes (day care and unemployment)	$38.0
Comprehensive Services Act	16.0
Title IV-E Revenue Offset (foster care)	13.8
Adoption Subsidy and Foster Care	16.8
S-CHIP and FAMIS Utilization	7.6
Child Support Enforcement – Fed.	4.9
Mental Retardation Training Centers	5.8
Shortfall in Va. Health Care Fund	24.0
Public Safety	
Adult and Juvenile Corrections	$19.5
Court-Appointed Attorneys Fees	13.3
EMS Hurricane Relief	7.2
Military Affairs – Recruitment, Other	4.8
State Police – Va. Criminal Info. Network Costs	3.2
Drug Courts – Replace Fed. Funds	2.8
Judgeships	2.0
HB 599	1.7
Forensics – DNA Backlog	1.1
Comp Board	
Jail Per Diems	$20.5
Staffing – Jails, Deputies, Cwealth Attnys.	12.8
Employee Benefits	
Health Insurance	$8.7
2nd Year VRS Amortization to 21 years	7.0
Higher Education	
Interest Earnings & Charge Card Rebate	$12.7
New Facilities Coming On-Line	4.9
Total	**$260.7**

Other traditional, high priority funding items

- Other adjustments, while not mandated or statutory, include second-year teacher salaries to 3 percent, and funding for capital project supplements and equipment.

Preliminary Funding Items	Biennial GF
Second Yr Teacher Sal. to 3% Inst. & Supt.	$40.0
Mental Health	
Divert Mentally Ill from Jails	$2.0
Local Inpatient Hospital Services	1.0
Public Safety	
Juv. Justice – Restore Substance Abuse	$1.5
Juv. Justice – Transitional Housing	1.0
Natural Resources	
State Park Operations	$3.9
CSO Match - Lynchburg	3.8
DCR Dam Safety Inspections	1.0
DEQ Solid Waste, Wetlands	1.2
Economic Development	
Enterprise Zones – avoid pro-ration	$4.0
Governor's Opportunity Fund?	5.9
VASCIC?	5.0
Capital Outlay	
Requested Project Supplements	$137.0
Equipment for New Facilities	41.6
GASB-Required OPEB Contribution	**$53.0**
VITA - Impact of Federal Recovery Rate	**?**
Total of about:	**$302.0**

Will resources be sufficient to cover additional spending?

- General fund savings of about $109 million are projected to help offset some of the additional spending.

Savings Item	Biennial GF
SOQ – Est. Revised ADM Enrollment	$49.0
Direct Aid Lottery/Sales Tax Net Adjust.	30.4
Car Tax (leftover from delinquent payments)	15.5
Debt Service Savings	9.2
MR Waiver Slots at Training Centers	5.3
Savings of about	**$109.4**

- Additionally, the K-12 sales tax correction (Ch. 10, 2006 Special Session 1) contributed $63 million in FY 2008 to a $113 million unappropriated balance.

General Fund Budget for 2006-08

	Biennial GF
Resources Available for Appropriation	$34,832.6
Operating Appropriations	$33,698.8
Capital Outlay Appropriations	1,020.7
Unappropriated Balance	**$ 113.1**

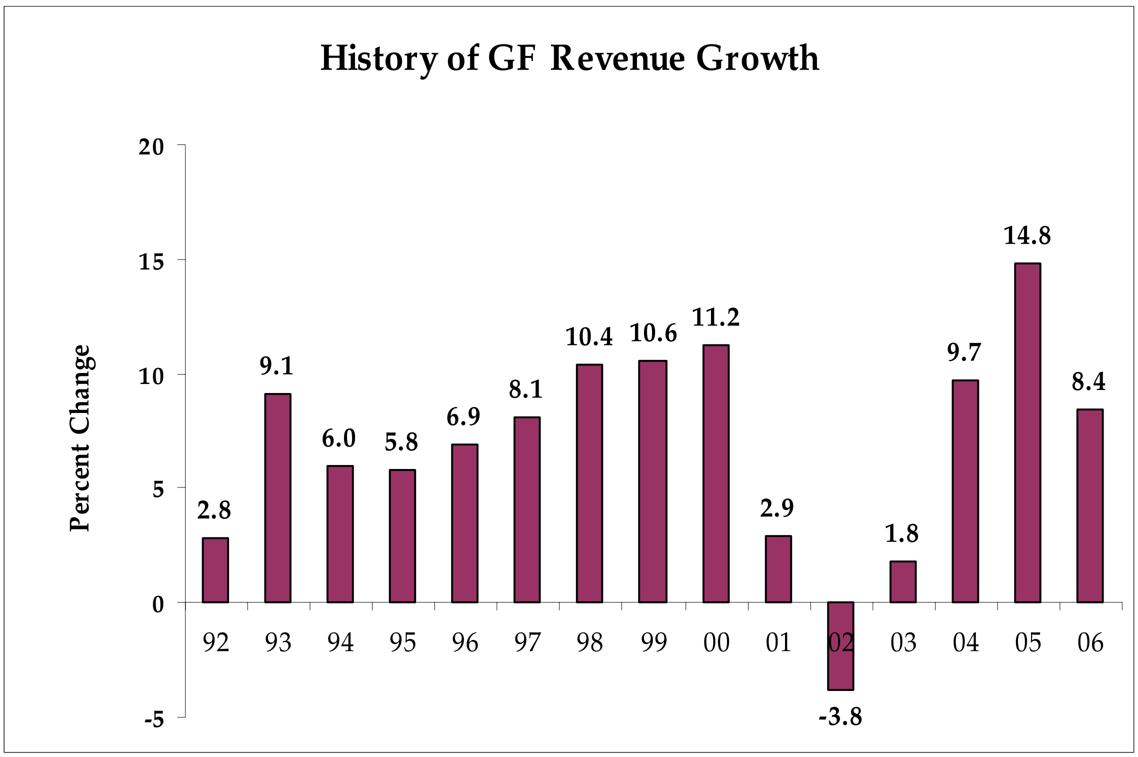
Will resources be sufficient to cover additional spending?

- Projected budget savings, plus a larger than normal unappropriated balance, will provide about $222 million – somewhat short of what may be required to cover budget items typically considered to be mandatory.

- However, you can expect additional general fund revenues above what has been assumed in the 2006-08 budget, to close the gap on mandatory items, and address other traditional, high priority funding items such as the second year teacher salary increase and capital project supplements.

Virginia's Revenue Outlook: First, a look back at 2006. . .

Revenue growth began to slow in FY 2006, as expected.



- However, the growth rate did not decline as much as anticipated in the December standard forecast.

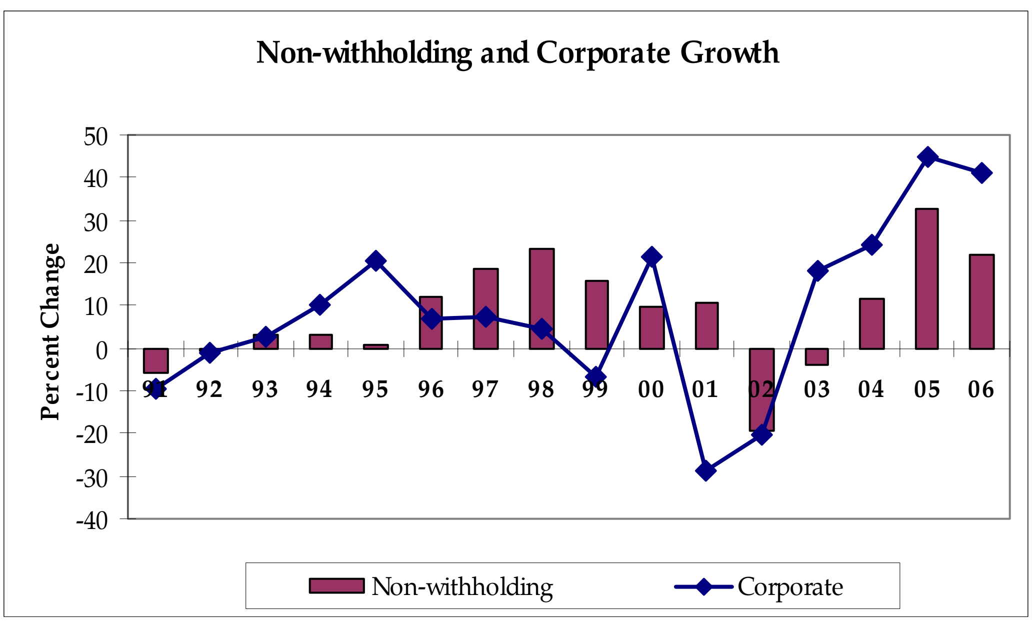
  - Non-withholding and corporate – two of the volatile sources that have fueled growth in recent years remained above trend.

Virginia's Revenue Outlook: First, a look back at 2006. . .

- Corporate growth in particular has remained resilient for an unprecedented period of time (4th straight year with high double-digit growth).

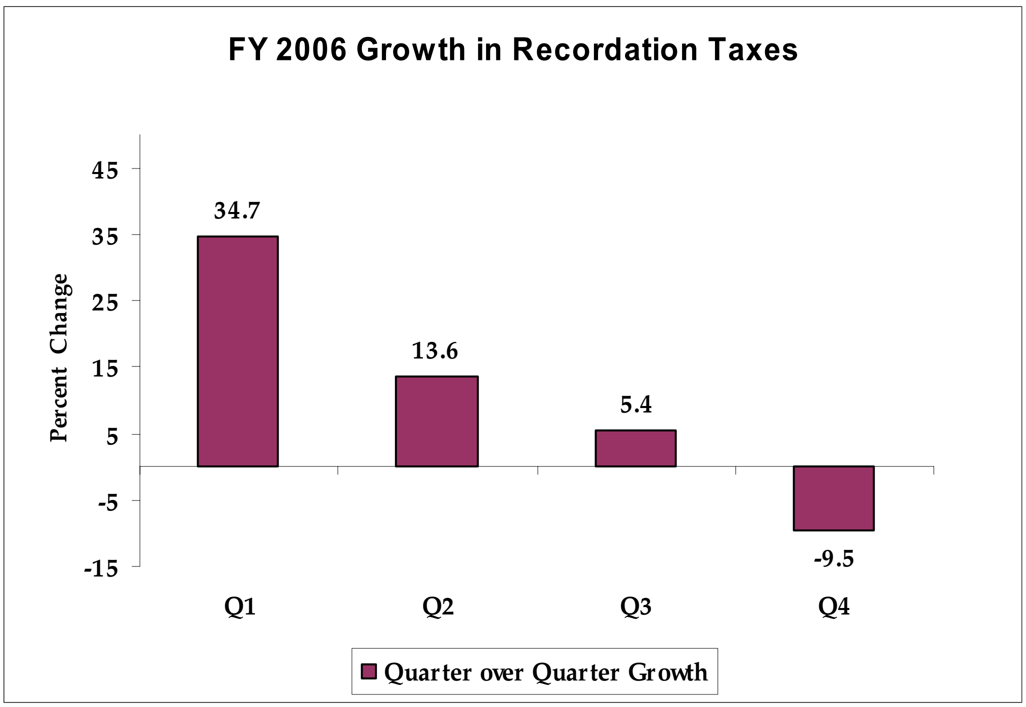
	FY 05 Growth Rate	FY 06 Growth Rate	December Projected Rate
Corporate	44.9%	41.3%	17.1%
Non-withholding	32.7%	22.0%	13.2%

- However, growth clearly is softening in these two sources, even though the exact timing of a major correction remains a question mark.



Virginia's Revenue Outlook: First, a look back at 2006. . .

- The picture for the third volatile source that has fueled growth in recent years is clearer – the slowdown in deed recording taxes that began last fall accelerated quickly in the spring.



- Forecast variance continues to be driven by these three volatile sources (non-withholding, corporate and deed recording taxes).

  - The major revenue sources of income tax withholding, net of refunds, and sales tax collections were within $50 million of the December forecast.

Virginia's Revenue Outlook: First, a look back at 2006. . .

- Fiscal Year 2006 ended with GF revenues of $19 million above the amount budgeted.

  - Delayed adoption of the budget during the 2006 session allowed the General Assembly to reflect actual revenue performance through April in its budget decisions.

- Actual growth rates for each revenue source are shown below:

Summary
FY 06 GF Revenue Collections
(millions of dollars)

	Actual	Annual Growth
Withholding	$ 8,061.0	7.3%
Non-withholding	2,530.2	22.0%
Refunds	(1,282.6)	3.9%
Net Individual	9,308.6	11.4%
Sales and Use Tax	2,812.7	(4.5)%
Corporate	871.6	41.3%
Wills, Suits, Deeds	694.7	16.6%
Insurance Premiums	373.8	0.1%
All Other	772.9	(3.7)%
Total GF Revenue	**$14,834.3**	**8.4%**

Virginia's Revenue Outlook: Turning to the current biennium. . .

Economics

Economic variables underlying Virginia's 2006-08 revenue forecast remain the same as projected last year.

	Job Growth	Wage/Salary Growth	Income Growth
FY 2006	2.2%	6.8%	7.2%
FY 2007			
Current estimate	1.7%	6.5%	6.7%
Estimate last yr	1.7%	6.4%	6.5%
FY 2008			
Current estimate	1.8%	5.6%	5.9%
Estimate last yr	1.6%	6.0%	6.0%

- Virginia will continue to outperform the nation overall.

- Job and income growth are unchanged for FY 2007; slightly higher job and slightly lower income growth for FY 2008.

- The GF revenue forecast is highly reliant on these economic variables since withholding and sales tax growth (which account for 75 percent of GF revenue) track wage/salary and personal income growth.

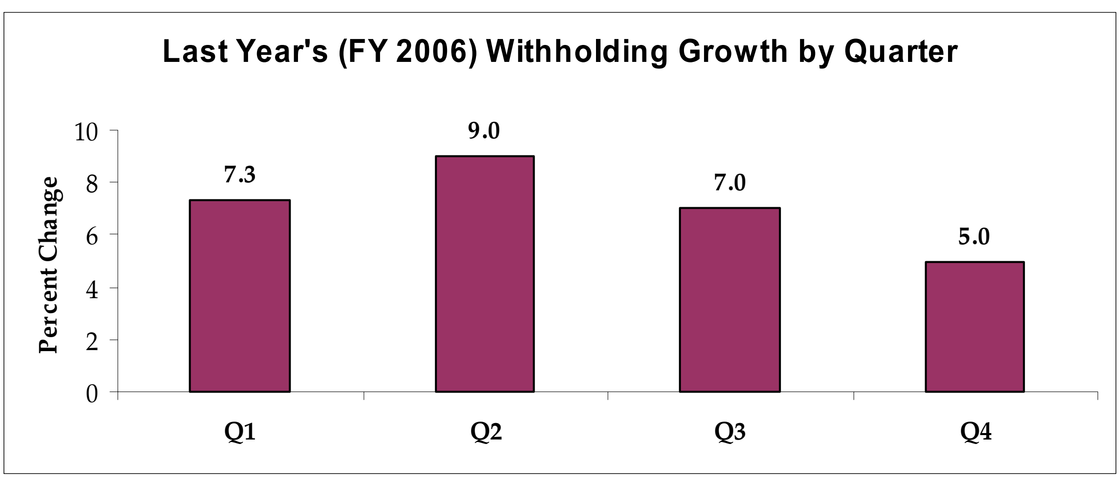
Virginia's Revenue Outlook: Turning to the current biennium. . .

- The current forecast already assumes a slowed growth rate for withholding and sales tax based on a cooling housing market and increased fuel costs.

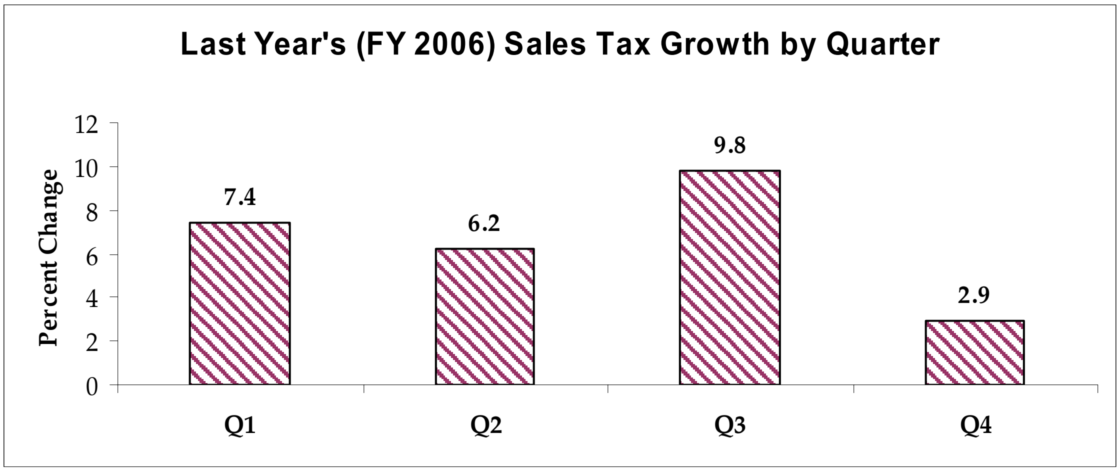
- Economic variables suggest that these growth rates adopted last December should hold; however, money in the bank trumps <u>projected</u> economics.

- First quarter collections for both withholding and sales are **<u>weaker</u>** than forecasted growth, suggesting the fall-out from housing-related activities is stronger than expected (Q1 withholding = 4.0 percent; Q1 sales tax = 3.8 percent).

  - To make up lost ground, the remaining three quarters must exceed growth for those same quarters last year, which are shown below:



Virginia's Revenue Outlook: Turning to the current biennium. . .



- It is unlikely that withholding and sales growth rates for the remaining quarters will be stronger than last year; therefore, growth rates for these two sources should be lowered slightly for FY 2007.

<u>Three Volatile Sources</u>

- Once again, it is the three volatile sources that will change the revenue forecast, rather than withholding and sales tax.

  Non-withholding
  Corporate
  Deed Recording Taxes

Virginia's Revenue Outlook: Turning to the current biennium. . .

Non-withholding and Corporate

- These sources are highly correlated.
  - Most taxpayers making estimated payments are small business owners.
  - Strong business profits translate into compensation increases that can affect final payments.

- These sources are the hardest to predict because they are influenced by investment decisions and other aspects of taxpayer behavior.
  - Taxpayers can avoid penalties/interest by remitting prior year tax liability and settling up in the spring.
  - Alternatively, taxpayers can overpay state liability to increase federal deduction for state taxes paid and then reclaim the dollars through a spring refund.
  - Corporations can carry back losses.
  - Taxpayers can decide when to realize capital gains.

Virginia's Revenue Outlook: Turning to the current biennium. . .

- These factors cause much of the revenue to fall in the final quarter; thus, it is useful to compare the first quarter growth rate with the "settle-up" quarter:

Non-withholding			Corporate		
	Q1	Q4		Q1	Q4
FY 2003	-2.7%	-3.4%	FY 2003	15.8%	22.5%
FY 2004	1.6%	16.8%	FY 2004	25.8%	27.1%
FY 2005	19.2%	35.5%	FY 2005	8.1%	21.4%
FY 2006	21.8%	24.6%	FY 2006	59.7%	22.3%
FY 2007	**5.3%**		**FY 2007**	**15.8%**	

- FY 2007 Q1 clearly reflects slowed growth but should remain in positive territory for the fiscal year, in light of stock market performance to date.

- The current forecast assumes negative growth this year for both sources; the forecast should be revised to increase this year's growth rate, thereby pushing more significant dampening into the first half of FY 2008.

  - Moody's Economy.com estimates a 36 percent decline in real estate commissions by next year.

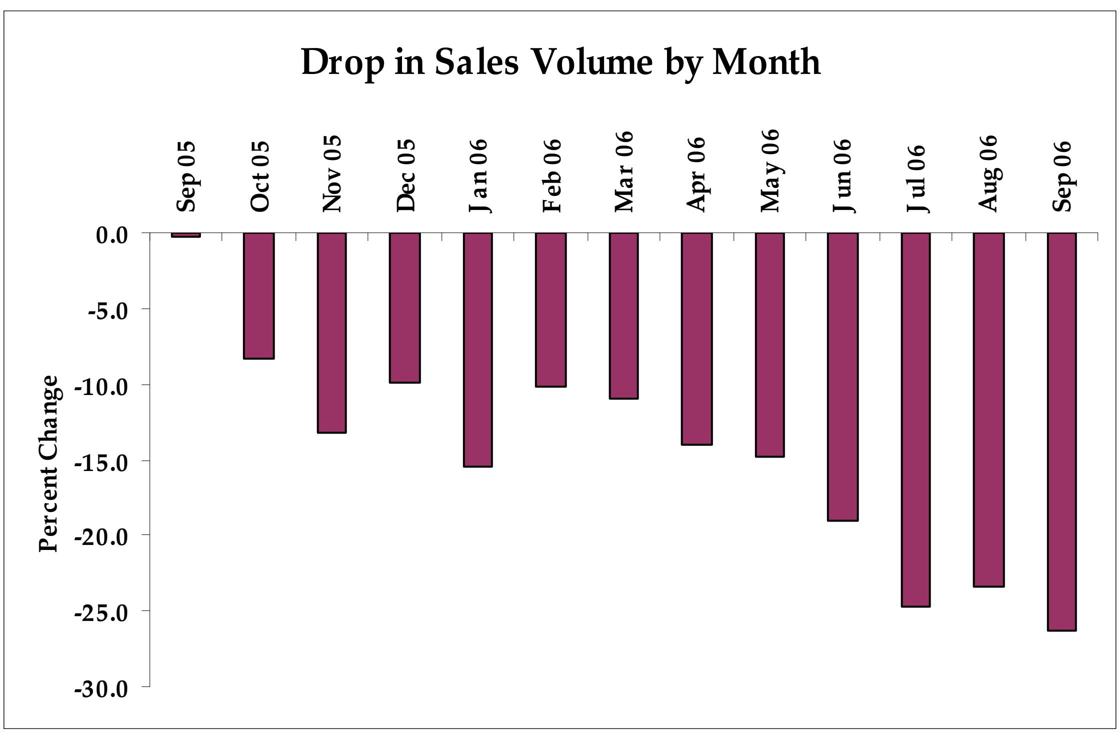
    -- This would translate into a loss of roughly $100 million in Virginia tax revenue.

Virginia's Revenue Outlook: Turning to the current biennium. . .

Deed Recording Taxes

- A major negative adjustment to the forecast will be required for deed recording taxes.

  - Housing market has cooled more quickly and dramatically than expected.
  - Drop in sales volume has accelerated.
  - Home price appreciation is flat to negative.
  - NOVA is characterized as one of the unsustainable national markets (where most of our previous strength in volume and appreciation has occurred).



Virginia's Revenue Outlook: Turning to the current biennium. . .

- First quarter collections are down 26 percent.

  - Reflects a 25 percent decline in homes sales, plus a 1 percent decline in average sales price.

- Things will likely get worse before they get better.

  - During FY 2006, home price appreciation of 18.1 percent helped to cushion the drop in sales volume; in the current fiscal year, a price drop in the 4-5 percent range could exacerbate the problem.

  - Pending home sales, a leading indicator for future recordation tax collections, declined 31 percent during September in Northern Virginia.

  - Pending sales likely understate the downside potential.

    -- Some buyers are walking away from active contracts and projects are being delayed or cancelled.

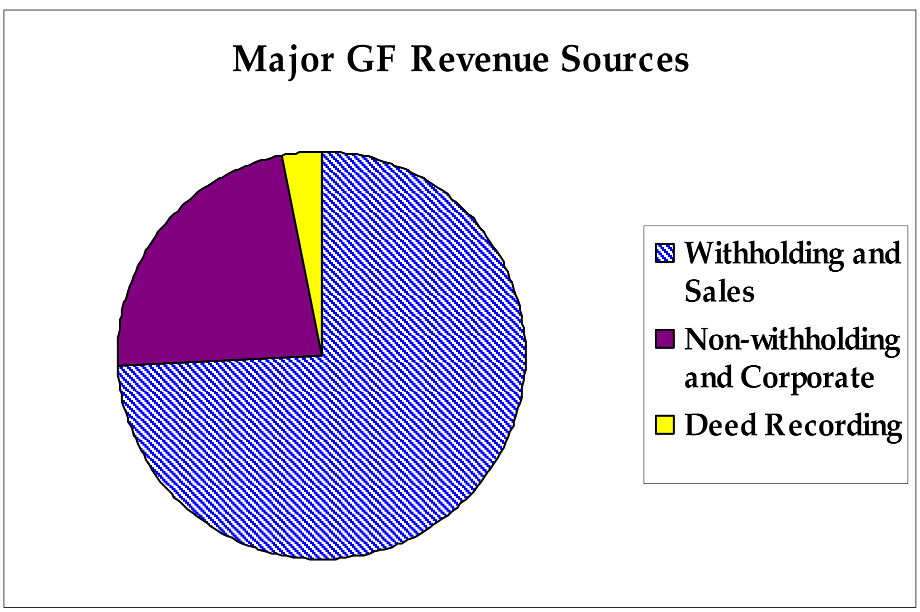
  - Until home prices stabilize, sellers will delay going to market or pull houses off the market.

Virginia's Revenue Outlook: Turning to the current biennium. . .

- The combination of declining home sales and a decline in average price could decrease recordation taxes by roughly a third this fiscal year.

  - This would likely create some pent up demand that will translate into growth in the number of homes sold during FY 2008; however, home price appreciation will remain in the pre-boom range of about 3 percent.

<u>Overall GF Revenues</u>



- Once again, three volatile sources that make up 25 percent of GF revenues will account for the lion's share of short session revenue adjustments.

SFC Revenue Forecast . . .

Summary

- Income and sales tax are essentially stable with a slight negative adjustment required.
- Non-withholding and corporate are continuing to slow but remain above the levels projected a year ago, requiring a FY 2007 positive adjustment to the forecast.
- Deed recording taxes will undergo a major negative correction in FY 2007, providing the basis for some growth in FY 2008.

SFC Staff Revenue Estimate
($ in millions)

Economic Growth Rates:*	FY 2007	FY 2008
Withholding	5.4%	6.0%
Refunds	4.2%	5.0%
Sales Tax	4.5%	5.9%
Non-withholding	9.1%	1.8%
Corporate	11.2%	-5.0%
Wills, Suits, Deeds	-33.0%	11.0%
GF Economic Growth Rate	**6.1%***	**4.6%***
GF Revenue Adjustment	+$**249.6**	**+$140.8**
Total Biennial Change		**+$390.4**

*Tax policy changes alter rates slightly

So, what are the caveats. . .

General fund revenues have gotten harder to forecast -- there's a lot that we just don't understand.

- A larger proportion of GF revenue rests on business profitability, related incentives paid to owners/key executives, and investment decisions (10 years ago, proportion was 17 percent; today, it is 23 percent).

  - As baby boomers retire, a much larger proportion of the population will be depending on investments and other non-wage income.

- Tax policy changes enacted in recent years are producing activity that could mitigate over time.

  - History shows that changes in capital gains tax rates, either up or down, generate increased capital gains realizations for a while.

  - It is not yet clear how much of recent activity relates to a backlog of realizations that were unlocked, versus a more lasting change.

- Virginia's reliance on federal spending has increased.

  - Homeland security spending is leveling off and war-time defense contracts will eventually follow the same course.

So, what are the caveats. . .

- There may be a new norm in the business world that we don't yet understand, i.e., businesses are not reacting the way they have in prior economic recoveries.

  - Business profits have been unusually high for an unusually long period.

  - To date, increased productivity has not flowed through to wages.

  - Capital investment spending has not increased commensurate with available cash.

- Some of the traditional economic relationships are being questioned.

  - What does an inverted yield curve mean today? It used to mean that a recession was around the corner.

- We are at the point in the business cycle where momentum has shifted; more pronounced economic adjustments will likely be felt when building the 2008-10 budget.

What does this all mean? Caution is our friend.

Summary: 2006-08 Revised Budget Picture

- The first call against the additional resources will be about $260 million in mandated and/or high priority funding items.

	Biennial GF
Resources:	
Unappropriated Balance	$113.1
Budget Savings	109.4
Estimated Additional Revenue*	390.4
Less Lottery Reforecast	(41.4)
Additional resources available:	**$571.5**
Mandated, high priority spending	about $260
Other, high priority/traditional	$200 to $300

**SFC Staff estimate*

- **Bottom line: some resources will be available for discretionary spending, but not as much as in recent years.**

- Other potential funding items include:
  - Remaining board-recommended SOQ revisions (FY 08 cost of about $104 million).
  - Higher education base adequacy (about $96 million to fully fund the guidelines), and financial aid (about $43 million).
  - Water quality and land conservation.

2008-2010 biennial budget looms large

- Growth in basic budget drivers will continue in the 2008-10 biennial budget.

  - Rebenchmarking of the Standards of Quality will likely top $1.0 billion –- again.

  - Medicaid typically grows at least 8 percent per year, or about $582 million for the biennium.

  - One new prison will come on-line in the next biennium, and one more will need to be constructed.

  - Debt service obligations will continue to grow as the 2002 capital program proceeds.

- Signs of a softening economy, especially in the housing market and federal spending, may be more apparent this time next year as you begin to craft the 2008-10 budget.

- Revenue and budget actions taken during the 2007 session could have implications for the 2008-10 budget.

  - To avoid creating a mismatch between spending obligations and on-going revenues, new spending commitments or tax policy changes should be fully funded in FY 2008.

Preview of 2007 Session…

- Additional resources above those assumed in the 2006-08 budget will be available.
  - Revenue growth and some budget savings, combined with a large unappropriated balance, provide sufficient resources to cover funding requests for mandated or high priority items.

- Fewer discretionary dollars will be available than in recent years.

- To the degree that discretionary funds are available, caution should be exercised to:
  - Avoid expanding obligations;
  - Avoid partially funding initiatives with major out-year costs; and
  - Continue to employ volatile, hard-to-project revenues for one-time uses.