Virginia Association of Planning District Commissions

State Budget Status and Future

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House Appropriations Committee

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State Budget Status and Future

- The rise and fall of state spending
  - Review of the late 1990's through 2003
- 2004 -2006 Biennial Budget
  - Competing budgets
- Fiscal Year 2004
  - What were the economist saying
  - We have a surplus?
- 2005 Session

The Rise and Fall of State Spending

Review of the Budget:

Late 1990's through 2003

Rise of State Spending

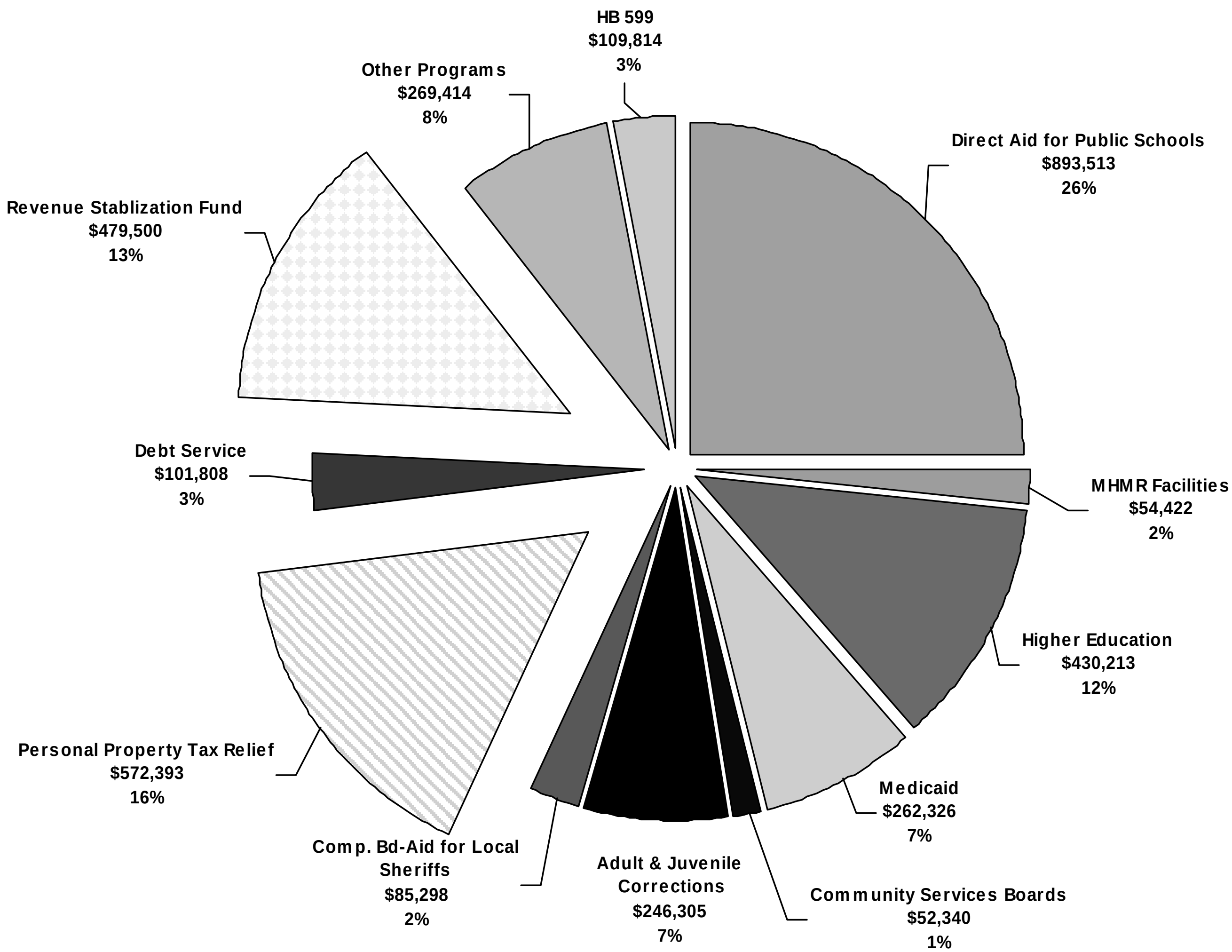
Review of the late 1990's through 2001

- 1996-1998 biennial budget was structurally balanced
- From 1998 to FY 2001, Virginia experienced strong revenue growth, with each year stronger than the last and healthy year-end surpluses
  - Three consecutive years of growth above 10 percent
  - Rainy Day Fund grew to $940.0 million
- Growth drivers of the early 1990's had abated
  - Corrections, Medicaid and K-12 enrollment
- New spending commitments were made
  - Car tax, tax policy changes (military income, double weight, coal tax credit, sales tax on food, etc), school construction, Medicaid provider rate increase, repaid the TTF, full funding of "599", deputy sheriff 1:1500, special pay and benefit increase for public safety employees, rollback and freeze of college tuition

General Fund Budget Growth FY 1998 to FY 2001

General Fund Budget Growth = $3,552.4 Billion

Dollars in Millions



2002 Recession: Managing the Budget Problem

Fiscal Years 2002 - 2004

Managing the Budget Shortfall

- Like the recession wrecked budget of the early 1990’s, the General Assembly managed the 2002 – 2004 budget shortfall without a general tax increase by employing a number of strategies

- Guiding principals adopted included:
  - No reductions to SOQ funding, minimized reductions to the “safety net” and to public safety

- Strategies to manage shortfall included:
  - Not approving new spending initiatives or program expansions
  - Examining all discretionary funding approved during the “bubble” period
  - Level funding or freezing programs
  - Containing Medicaid growth: reducing indirect care inflation, containing drug cost
  - Eliminating programs that are not statewide
  - Reviewing programs for alternative funding, i.e., federal funds, fees
  - Eliminating/consolidating agencies and facilities
  - Lifting the 6-year freeze on college tuition
  - Issuing debt for previously approved capital projects – freed up cash
  - Examining saving opportunities with the VRS
  - Implementing targeted and across-the-board reductions – both GF and NGF agencies

2002 Session
Chapter 814 (HB 29)
"Caboose Bill"

- FY 2002 budget gap nearly $1.5 billion
  - Revenue shortfall = $1,230.6 million
  - Spending pressures = $277.8 million
- Given the limited time left in FY 2002, HB 29 attempted to manage the budget problem rather than fix it

Chapter 814 (HB29)

Actions to Close Budget Gap

Action	$ in Millions
Balances *(includes $87.2 mil from capital projects)	*$102.8
Rainy Day Payment	467.0
Medicaid Upper Payment (IGT)	259.0
Acceleration of Sales Taxes	139.0
Supplant GF with NGF	205.5
Budget Cuts	95.9
Technical Forecast Reductions	55.6
Lower VRS Rates	78.5
Delay Comp. Board Payment	35.1
Car Tax at 70%	13.5
Misc. Transfers and Recoveries	103.6
Total:	**$1,555.5**

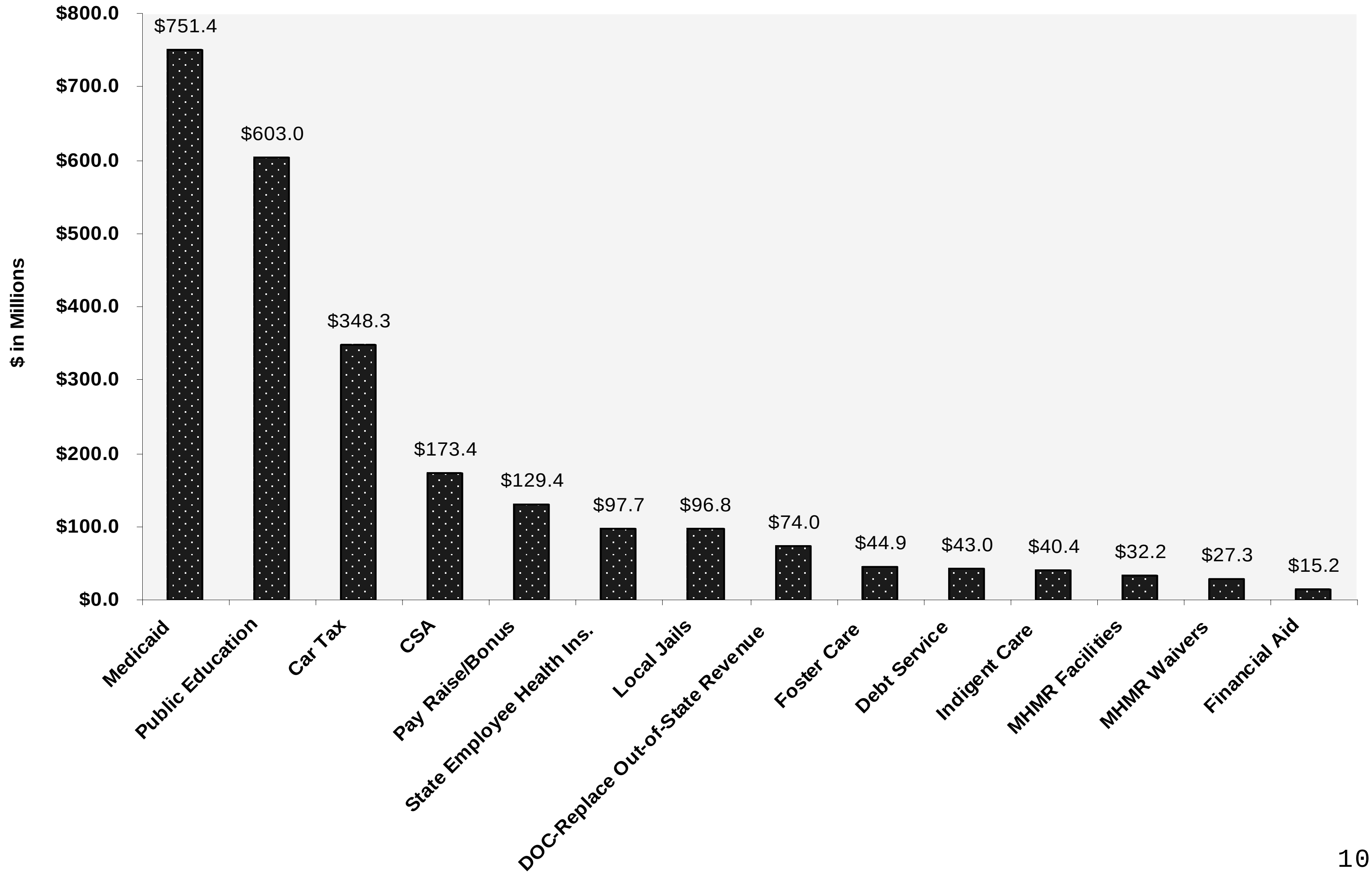
2002-2004 Budget
Chapters 899 & 1042

How was the gap closed?

- Combination of insufficient revenues and spending pressures resulted in:
  - FY 2003 shortfall = $2.3 billion
  - FY 2004 shortfall = $2.1 billion
- Budget cuts represented 33.4 percent of the actions
  - Cuts to state agencies represented about two-thirds
  - Higher Education represented 40% of state cuts
- Fee increases account for 6.3 percent
- VRS rate adjustments accounted for 6.1 percent

Major Spending Pressures in 2002-2004 Budget

Totals = $2,477.0 Billion



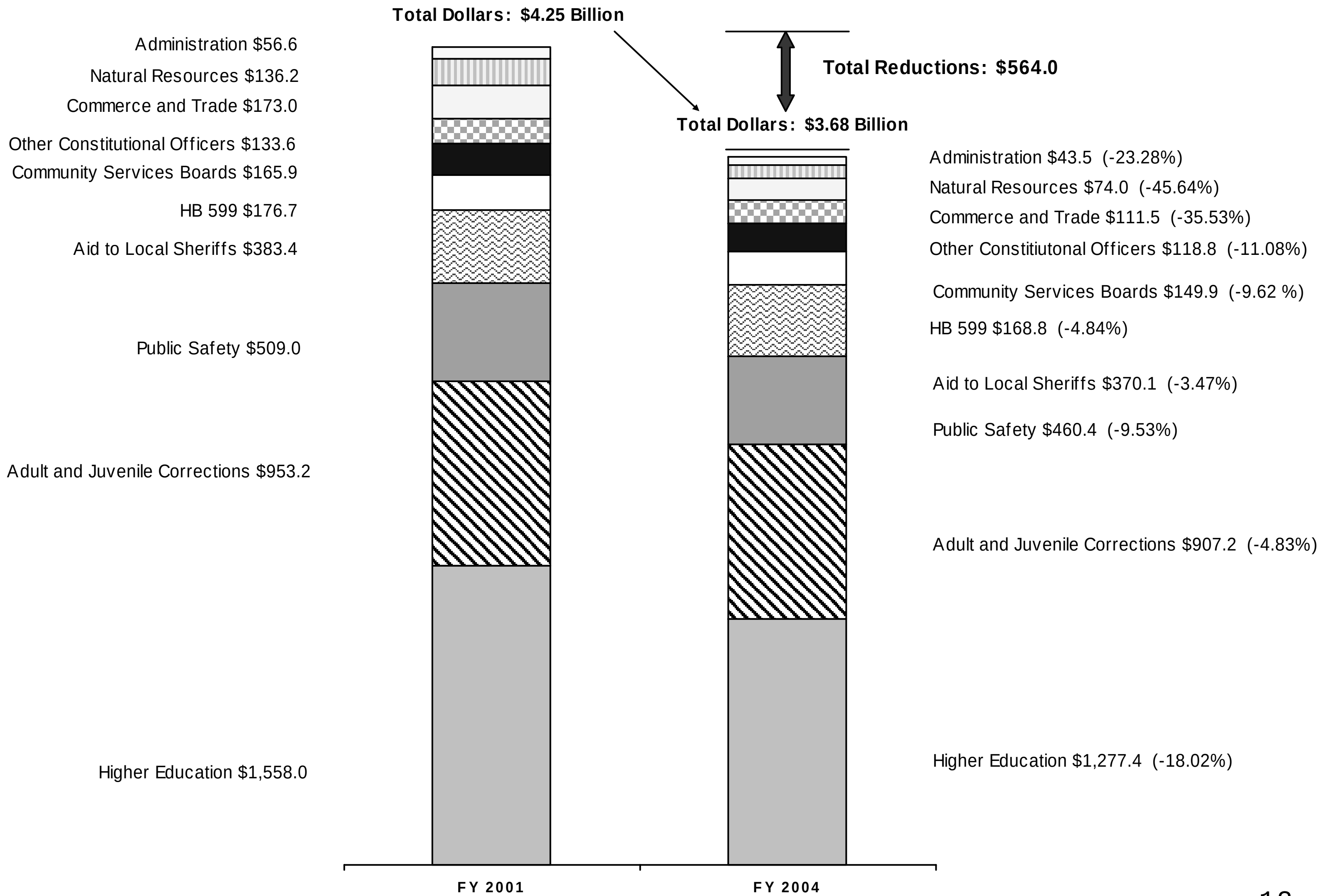
2002-2004 Budget

Actions to Close Budget Gap

Action	$ in Millions	Percent of Total
Reductions to Gen. Fund Agencies *(Includes Medicaid containment strategies)*	$1,001.6	23.0%
Non-general Fund Transfers *(includes budget reductions, i.e., DMV, VDOT)*	725.7	16.7
Reductions to Local Aid	452.6	10.4
Rainy Day Fund	374.4	8.6
Half-cent Sales Tax From TTF	317.0	7.3
Fee Increases	276.3	6.3
VRS Rate Reductions (GF&NGF)	265.8	6.1
Tax Policy/Revenue Changes	239.0	5.5
Literary Fund for Teacher Retirement	231.3	5.3
Supplant General Fund Dollars	124.4	2.9
Freeze Car Tax at 70%	118.8	2.7
Use Debt for Capital Projects	98.1	2.3
Other Actions	70.0	1.6
Technical Forecast Adjustments	58.4	1.3
Total:	$4,335.4	100.0%

Percentage Reductions in the GF Appropriations of Select Areas Comparing FY 2001 to FY 2004

($ in Millions Unless Otherwise Noted)



Use of One-time Actions 2002-2004 Budget

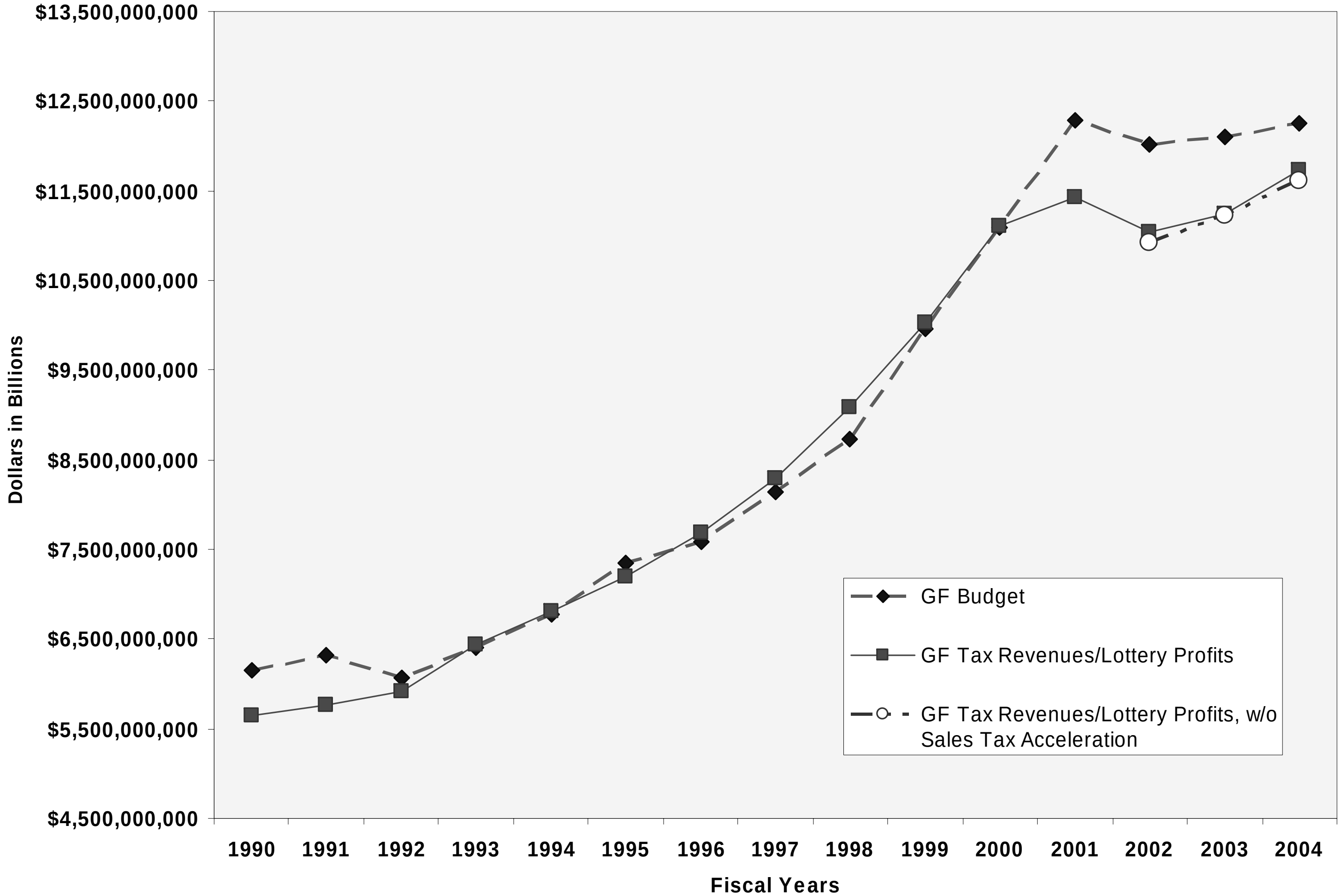
- Chapter 899 and Chapter 1042 used one-time actions to help “manage” the budget problem
  - The use of one-time actions in FY 2004 create a structural imbalance in the 2004-2006 budget
  - One-time “fixes” include actions that are not ongoing (Rainy Day Fund, Tax Amnesty, Capital Balances) or that require overriding the Code (Transportation funds, Game Fund, $4-for-Life)

- In total, Chapter 899 and Chapter 1042 contain approximately $500.0 million in FY 2004 one-time actions, excluding Literary Fund and sales tax acceleration
  - Some of these Code overrides could be continued next biennium
  - Literary Fund transfer totals $118.7 million in FY 04
    - Can be used for Teacher Retirement under the Constitution
  - Sales tax acceleration totals $139.0 million

- During the 1990’s recession, one-time actions were also used to help manage the budget problem

General Fund Appropriations Compared to General Fund Tax Revenues and Lottery Profits

1990 - 2004



2004 -2006 Biennial Budget

Preparing the 2004-2006 Biennium

- What does it cost to keep doing what we are doing?
  - Base budget
- What are the known budget drivers?
  - Mandatory and statutory
- What are the "discretionary" priorities?
- How does it all fit?

2004-2006 DPB Base Budget

- DPB develops the base budget which equals FY 2004 appropriations, adjusted for one-time spending and annualized costs
  - Annualize 2.25% salary increase, removed equipment, relocation costs, and VRS savings

- Base budget does not include:
  - Any spending or ongoing savings that may be contained in the “Caboose Bill” - i.e., Medicaid costs ($140.0 million), Hurricane Isabel costs ($48.0 million), or Car Tax savings ($35.0 million)
    - FY 2004 additional revenues should cover these costs
  - Spending increases driven by State or Federal Law
    - SOQ re-benchmarking, Medicaid, CSA, Foster Care payments, state employee health insurance, VRS rate changes, economic development incentive payments, jail payments
  - Any discretionary spending
    - Salary increases, funding for higher education, funding for “Homeland” security, mental health, or capital outlay projects

2004-2006 DPB Base Budget

(GF Dollars in Millions)

Chapter 1042 (FY 2004 Base)	$12,259.2
Annualize FY 2004 Salary Increase	$31.0
Removal of VRS Related Savings	$45.1
Governor's Opportunity Fund and Other Adjustments	$3.2
"One-time" and "Other" Adjustments	($8.3)
DPB Resource Base Budget Target*	12,330.2

*Fiscal Year 2006 Base Budget is $12,328.0, reflecting the phasing out of CIT funding.

2004-2006 Budget Drivers

- Two types of budgetary pressures
  - Statutory: Driven by federal or state law i.e., Medicaid, SOQ, “Rainy Day” fund, adult and juvenile corrections, VRS, debt service
  - High Priority: Driven by historical commitments or enrollment demands i.e., MR waivers, higher education (in-state students, financial aid), indigent care at teaching hospitals

- Other budget pressures
  - Employee compensation, maintenance of facilities

Economic Outlook
2004-2006 Biennium
Based on Fall 2003

- Overall, general fund revenues were expected to grow around 5.4 percent each year
  - Withholding revenue growth expected to be in the 5.9 percent range
  - GF revenue growth above projected forecast is possible if jobs, and wage and salary growth accelerate towards trend levels

- Increased corporate profits will lead to greater equipment investment by companies and will spur job growth, which is expected to accelerate as companies begin to hire
  - Job growth for 2004-2006 is expected to be slightly below trend

- Wage and salaries will improve as job market rebounds
  - Growth is expected to be below trend

What Did It All Mean?

- Based on the outlook, mandatory spending requirements consume revenue growth
  - Limited flexibility in discretionary spending

- Depending on funding decisions, alternative strategies would be required to manage the gap between forecasted revenues and budget drivers

The Governor's Budget Proposal

Overview of Governor’s Budget

General Fund Budget

- Using the baseline revenue forecast, approximately $1.8 billion in net new general fund resources were anticipated in HB 30 after base budget adjustments
- Net new spending totaled approximately $3.0 billion
  - Total spending equaled $3.9 billion
  - Savings contained in budget totaled approximately $900.0 million
    - Includes $570.6 million in savings for K-12: $418.2 million by deducting certain local and federal revenues “off the top”, $109.7 million deduct technology from SOQ costs, $30.8 million from Literary fund
    - About $150.0 million in savings and spending are technical adjustments
- Remaining budget gap was approximately $1,167.9 million
- Governor’s tax proposal generates approximately $1,177.1 billion

2004-2006 Major Spending Drivers:

SOQ, Medicaid, Public Safety, Car Tax, Rainy Day Fund, and Debt Service

Totals - $2,259.5 Billion

- Biennial cost of re-benchmarking SOQ - $1,157.6 billion
- Biennial Medicaid utilization and inflation updates - $707.8 million
- Public Safety ,corrections/jails - $153.2 million
- Maintaining Car Tax relief at 70 percent - $103.4 million
- Required "Rainy Day" fund deposit in FY 2006 - $87.0 million
- Debt Service on G. O. Bonds - $50.5 million

HB 30 General Fund Resources and Spending

$ in millions	FY 2005	FY 2006	Biennium
FY 2004 Net Balance Forward	$357.4		$357.4
GF Revenue (baseline forecast) includes Lottery and Transfers	$12,736.6	$13,366.2	$26,102.8
Total Resources Available	$13,094.0	$13,366.2	$26,817.6
Base Budget (FY 2004 adjusted)	$12,332.3	$12,332.0	$24,664.3
Net Resources Available Over Base Budget	**$761.7**	**$1,034.2**	**$1,795.9**
HB 30 Increased Spending	$1,556.7	$2,324.0	$3,880.7
HB 30 Savings	$454.2	$463.0	$917.2
Budget Gap	($340.8)	($826.8)	($1,167.6)
Governor's Tax Proposal	**$504.5**	**$672.6**	**$1,177.1**

Budget Adopted by the General Assembly

House and Senate Budgets Two Different Paths

- Respective budgets reflected different approaches to balancing the budget
  - Both budgets assumed the need for additional revenue above normal economic growth
    - House assumed less revenue than Governor's proposal. Senate budget assumed more revenue with new investments in public education and transportation
      - Senate subsequently dropped the transportation package - $1.5 billion
  - Both budgets shared many common features
    - Preserving the triple A bond rating
    - Re-benchmarking of SOQ, full funding for Medicaid, new investment for higher education in order to address enrollment growth and moderate tuition increases
  - Major sticking point was funding the new Standards of Quality

Final Revenue Package
House Bill 5018 and Senate Bill 5005

- On April 28, 2004 the General Assembly adopted HB 5018 which is expected to generated $1.45 billion in net additional revenue over the 2004-2006 biennium. Key components include:
  - One-half cent increase in sales tax increase: one-quarter to the General Fund; one-quarter earmarked for public education/tax relief
  - Increase in cigarette tax: 17.5 cents in FY 05 and $27.5 cents in FY 06 (20 cents and 30 cents)
    - Revenue is deposited into a special health care fund
  - Modification to the senior age deduction: grandfathers everyone that was 65 on January 1, 2004. Establishes a means test for persons turning 65 after January 1, 2004.
  - Increase in recordation tax: 10 cent per $100 increase in recordings
  - Reduces taxes: 1.5 cent phase-out of food tax starting July 1, 2005, increased the personal exemption from $800 to $900, eliminates the marriage penalty

- SB 5005 - Capped car tax at $950 million per year
  - Effective July 1, 2006
  - Localities will receive a percentage shared based on CY 2005 reimbursement
  - Localities will be required to set tax rates that provide relief for personal vehicles valued at $20,000 and less
    - Establish a base rate applied to all vehicles below $20,000 and a separate rate for values over $20,000
    - Business vehicles will be assessed a single rate

The Budget Adopted by the General Assembly

- The final budget adopted by the General Assembly made significant new investments in education, health care and rebuilding the “Rainy Day” fund. Key components include:
- Rebuild the Rainy Day fund: $87.5 million “super” deposit
  - Expected balance should exceed $430 million by end of biennium
- Public Education:$1.8 billion
  - $1.2 billion for biennial re-benchmarking
  - $325 million to address the revised SOQ standards
  - Quarter-cent (HB 5018) split half for school age population and half distributed through the SOQ
- Higher Education: $250 million
  - $175 million to address base adequacy
    - Moderate tuition increases and meet expected enrollment growth
- Medicaid: $707.8 million for full funding for utilization and inflation
  - Increased provider reimbursements for hospitals and nursing homes
- New investment in community based services for MHMR/disability
  - 700 new MR waiver slots, 300 day support waiver slots, 105 DD waiver slots
- New investment in water quality and land conservation efforts
  - $30 million to address point and nonpoint water pollution control efforts, $5.0 million for the Virginia Land Conservation Fund

Virginia Economy Fiscal Year 2004

What were the economist thinking?

Virginia will have a surplus!

FY 2004 Economic Outlook
Based on Fall 2003

- Fiscal year 2003 job growth was flat at 0.2%, but performed better than the "official" forecast of negative 0.4%
  - Northern Virginia job growth positive since January 2003
- Fiscal year 2003 personal income and wage and salary growth performed below the "2002 official" forecast
  - Personal income grew 3.3% vs. 5.4%
  - Wages and salaries grew 2.4% vs. 3.2%
- The economic growth assumptions consistent with a normal post-recession pattern
  - Consistent with slower job growth, both personal income and wage and salaries were not expected to grow as strong in FY 2004
  - Outlook projects that Virginia will out-pace the nation in job growth
    - Job growth was forecasted to improve in FY 2005 and 2006
    - Led by Northern Virginia

FY 2004 Economic Outlook

Based on Fall 2003

- Following a recession, there is typically a “bounce” as the economy rebounds and jobs are created and consumers begin to spend
- Because the 2001 recession was half the magnitude of the 1991 recession, it was assumed the “bounce” and the subsequent rebound would be more mild
  - Financial (2001) vs. employment (1991) recession
  - Jobless recovery
- Why did economist believe this?

The Tale of Two Recessions

1991 vs. 2001

- *1991 recession:*
  - Virginia was among the first going into the recession
  - Duration: 12 months (March 1990 – March 1991)
  - Two-years negative employment growth (1991 and 1992) 62,000 job loss on fiscal year basis
    - Unemployment rate peaked at 6.4%
  - Collapse of the real-estate market (Northern Virginia)
    - Speculative building
  - Decreased defense spending (Cold War over)
  - Weak consumer spending
    - Sales tax revenues went negative

- *2001 recession:*
  - Duration: 8 months (March 2001 – November 2001)
  - 36,000 job loss on fiscal year basis (2002)
    - Unemployment rate in 2002 was 4.1%
    - September 2003 was 3.7%
  - Real-estate market did not collapse
    - Housing values remained strong
  - Strong consumer spending
    - Sales tax did not go negative
  - Sharp decline in stock market
    - Nonwithholding tax revenues went negative
  - Collapse of telecommunication Industry (Northern Virginia)
    - Wage and salary growth stagnated – declined in some industry sectors

The Tale of Two Recessions

1991 vs. 2001

- The 2001 recession was more a "financial" recession than an "employment" recession
  - Collapse of the financial markets, IPO's, and "high-tech" industry
  - Stock options, bonuses, high salaries
- Withholding and sales tax stayed positive
  - Softness in job growth and wages have resulted in below trend growth
    - Wage and salaries in some industry sectors declined
- Nonwithholding and corporate taxes fell dramatically from their peak
  - FY 2003 nonwithholding taxes were $404 million below FY 2001, decline was 5 times larger than in 1991-1992
  - FY 2003 corporate tax receipts were $166.6 million below FY 2000
- 25 percent of the revenue increase from 1998-2001 came from nonwithholding taxes
  - Approximately 60% of the total decline in FY 2002 revenues resulted from nonwithholding

Fiscal Year 2004 Performance

We have a surplus!

FY 2004 General Fund Revenue Collections Through May

We got the bounce!

- Through May, tax collections were 9.3 percent over the same period last year
  - Fiscal year forecast assumed a 6.7 percent growth rate
    - The growth rate was revised upward in the fall of 2003 from 4.6%
  - Income and sales tax exceeding forecast
    - Two sources account for 82 percent of GF revenue
- Strong job growth in Virginia
  - Virginia is the second fastest growing state
    - January 2004, Virginia recovered all job losses from 2001 recession
    - March 2004, Virginia's economy is expanding – number of jobs exceed 2000 peak
  - NoVA grew 4.1 percent in April
    - Accounts for 67 percent of all new jobs created in the state
    - Loudon and Prince William Counties lead the nation in job growth
    - Continued federal spending – Homeland security and defense
- Strong consumer purchasing
  - Through March, retail sales are up over 12 percent, highest year-over year increase since 1994
  - Strong job growth, continued refinancing, tax refunds, and improvement in wages

How Large will the FY 2004 Surplus Be?

- Based on preliminary June deposit data, FY 2004 annual growth rate is anticipated to exceed the official forecast by 2.5 percent
  - General fund revenue surplus is projected to be approximately $300.0 million
- Revenue surplus does not reflect unexpended agency balances or Lottery transfers

Commitments Against FY 2004 Surplus

- Rainy Day Fund
  - 50 percent of surplus must be deposited as required under the Constitution
  - 25 percent "super" deposit required by Code
    - Legislation adopted in 2003
    - Governor required to submit a budget amendment to 2005 Session making the deposit
- Water Quality Improvement Fund
  - 10 percent of the surplus
- Sales tax distribution
  - One-third of sales tax surplus must be set aside for distribution based on school age population
- Personal Exemption
  - HB 5018 requires the implementation of the personal exemption increase effective January 1, 2005
- Maintenance Reserve
  - Due to September effective date of HB 5018, budget unallotted $40.0 million for maintenance reserve
  - After funding the increase in the personal exemption, the Governor can re-allot the funding
- Hurricane Isabel
  - Actual costs are expected to be $25 to $30 million greater than anticipated

2005 Session

What are the issues?

2005 Session

- The FY 2004 surplus will have a ripple effect in FY 2005 and 2006
  - FY 2004 actual collections form the “base” in which the forecasted growth rates apply
  - If surplus is $300 million a corresponding increase is made for FY 2005 and 2006
- The actual revenue adjustment could be plus or minus the FY 2004 surplus
  - Adjustments will be based on the economic forecast for jobs and wage and salary growth
    - Both factors are performing greater than the forecast
  - Analysis of each of the revenues sources to determine whether the surplus was driven by economic factors or by one-time events that may not be sustainable
    - Capital gains, recordation taxes, etc

2005 Session

Restraint Should be the Rule

- Several spending issues need to be addressed
  - Accelerated sales tax collections
    - Need to correct this one-time accounting action. Cost could be $181.0 million
  - Sales tax distribution for public education
    - One and one-quarter cents is dedicated for K-12. Any upward revision to sales tax will result in additional funding
  - Enrollment driven programs
    - Medicaid, K-12, Higher Education, Corrections
  - Employee compensation and health insurance
    - General Assembly provided a 2 percent compensation reserve. Actual salary increase will need to be addressed
    - Second year health insurance premium increase is not budgeted
  - Transportation – VTA 2000
    - One-third insurance premium tax dedicated to transportation
- Beyond addressing current spending pressures, spending should be restrained to one-time actions versus program expansion or new initiatives that increase the operating base
  - Capital projects: A number of capital projects approved by the voters are coming in over bid. Projects could be supplemented using cash instead of increased borrowing
- 2006-2008 Biennial Budget
  - Required Rainy Day Fund deposits based on FY 2005 and FY 2006 revenues
  - Food Tax Reduction. HB 5018 provided for a three year phase-out of the food tax. The final two half-cent reductions occur in FY 2007 and FY 2008
  - Biennial updates for SOQ and Medicaid re-basing