A Review of Virginia's State Budget

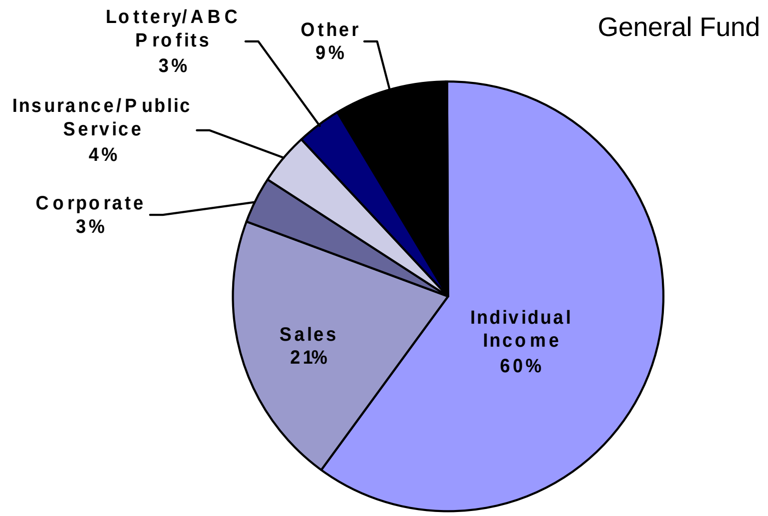
Robert P. Vaughn, Staff Director
House Appropriations Committee
August 17, 2004

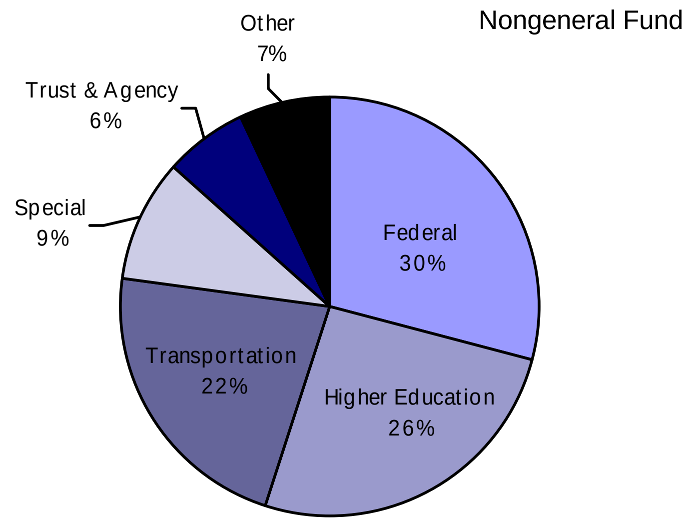
State Budget Status and Future

- Understanding the budget
  - Where state revenues come from
  - Where the general fund budget goes
- The rise and fall of state spending
  - Review of the late 1990’s through 2003
- 2004 -2006 biennial budget
  - Competing budgets
- Fiscal Year 2004 revenue collections
- 2005 Session budget issues
  - Restraint

Where Do Revenues Come From

- State revenues are defined as either general funds or nongeneral funds.
- General fund revenues include income taxes, sales tax, and corporate taxes; and can be used for any purpose, but is primarily used for education, public safety and social services.
  - 47 percent of the budget is derived from general fund revenues
- Nongeneral funds include federal revenues, tuition and fees, and gas taxes; and are generally earmarked for a specific programs.
  - 53 percent of the budget is derived from nongeneral fund revenues

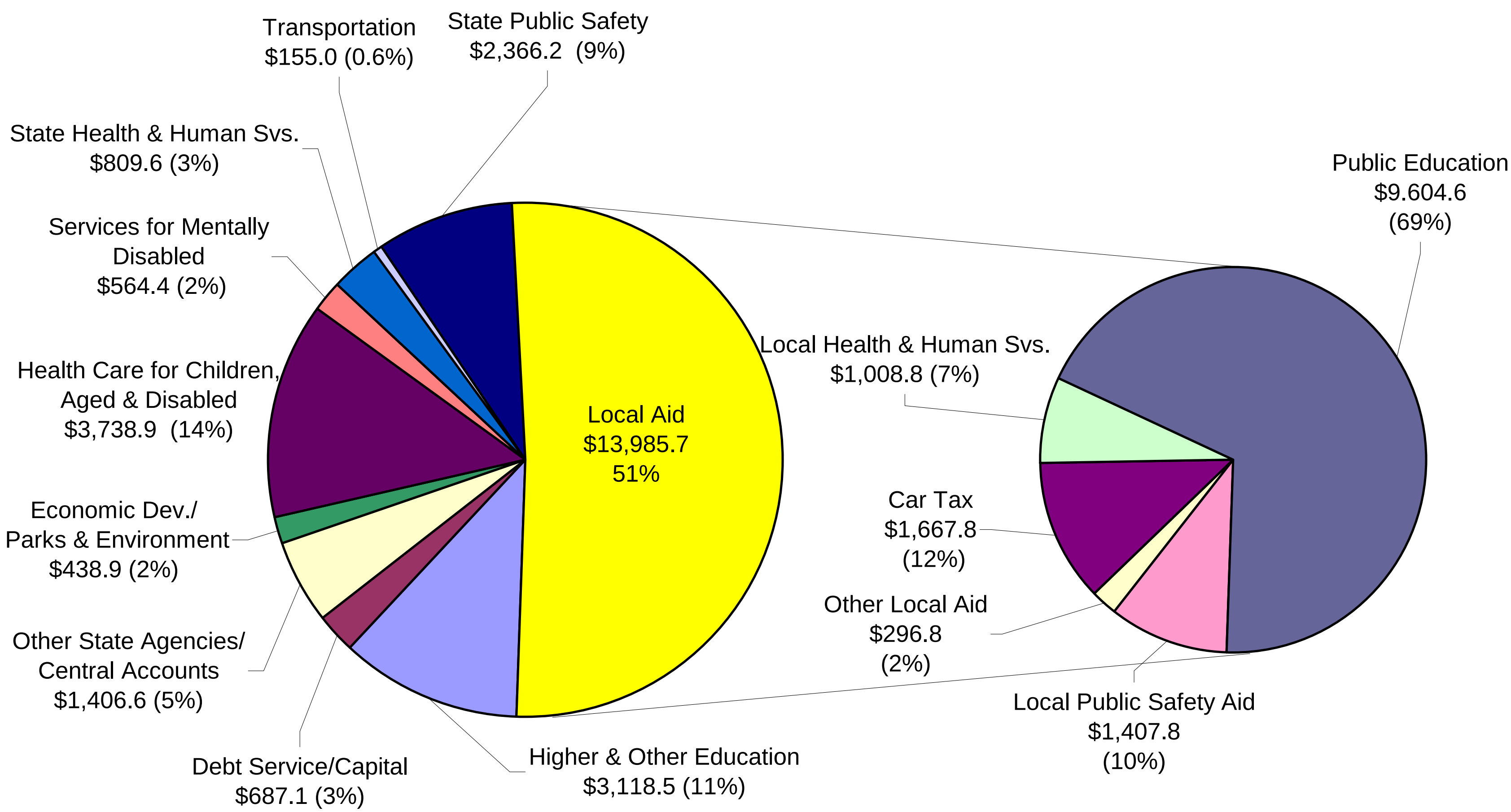




General Fund Appropriations FY 2004-2006 = $27,270.9

HB 5001, as adopted

($ in millions)



The Rise and Fall of State Spending

Review of the 1990-2003 Budget: Boom and Bust

Rise of State Spending

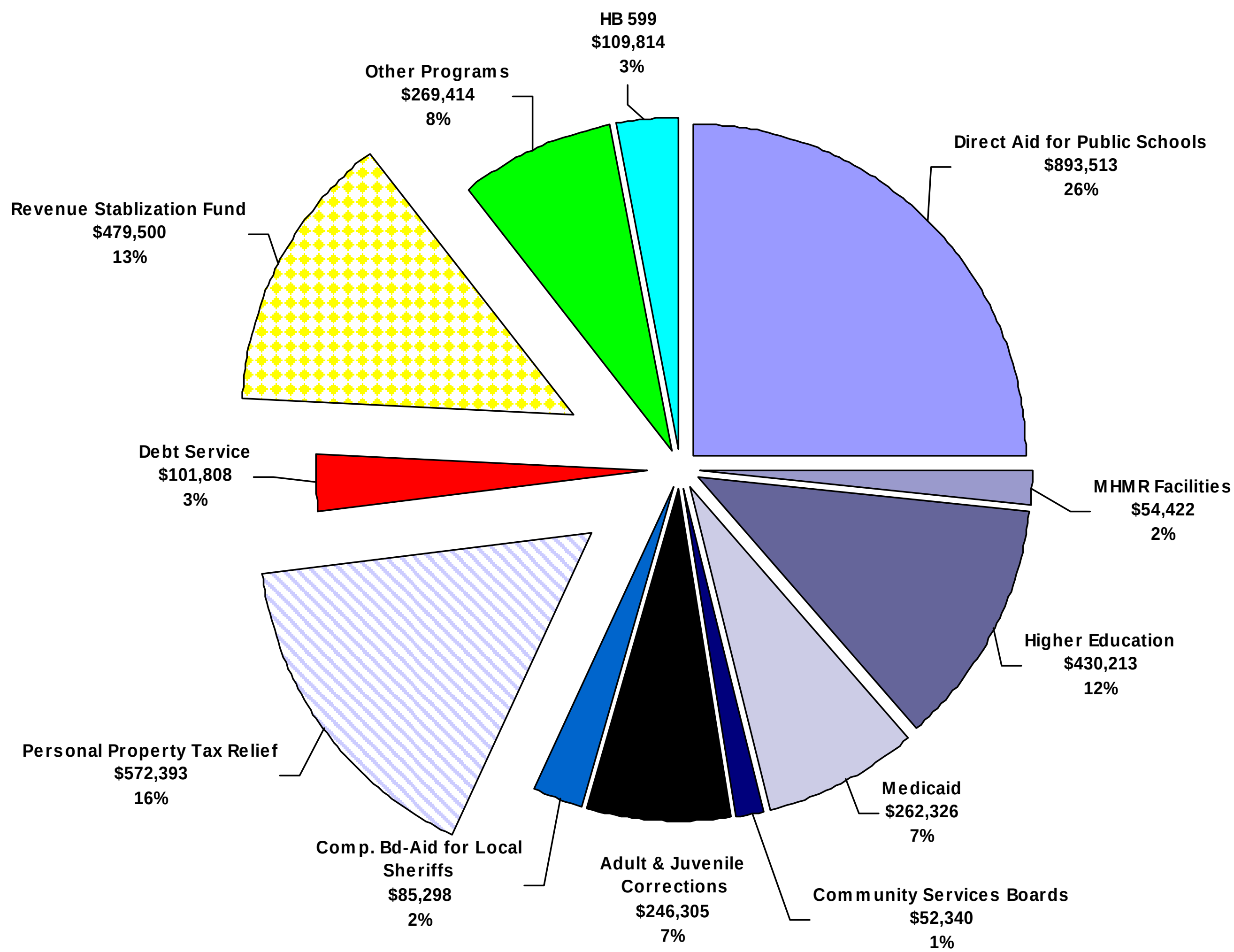
Review of the late 1990's through 2001

- 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
- But new spending commitments were made
  - Car tax, tax policy changes (military income, reduce sales tax on food, etc), school construction, Medicaid provider rate increase, full funding of "599", deputy sheriff 1:1500, special pay and benefit increase for public safety employees, rollback and freeze of college tuition
- Affordability of new commitments based on extra-ordinary revenue growth

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

- The General Assembly managed the 2002 – 2004 budget shortfall without a general tax increase

- 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 costs
  - Eliminating programs that were 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

”Caboose Bill” – FY 2002

- 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, budget attempted to manage the budget problem rather than fix it

Actions to Close Budget Gap – FY 2002

House Bill 29 Action	$ in Millions
Balances	*$102.8
*(includes $87.2 mil from capital projects)	
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**

Closing the Budget Gap
2002 and 2003 Sessions

Spending Pressures

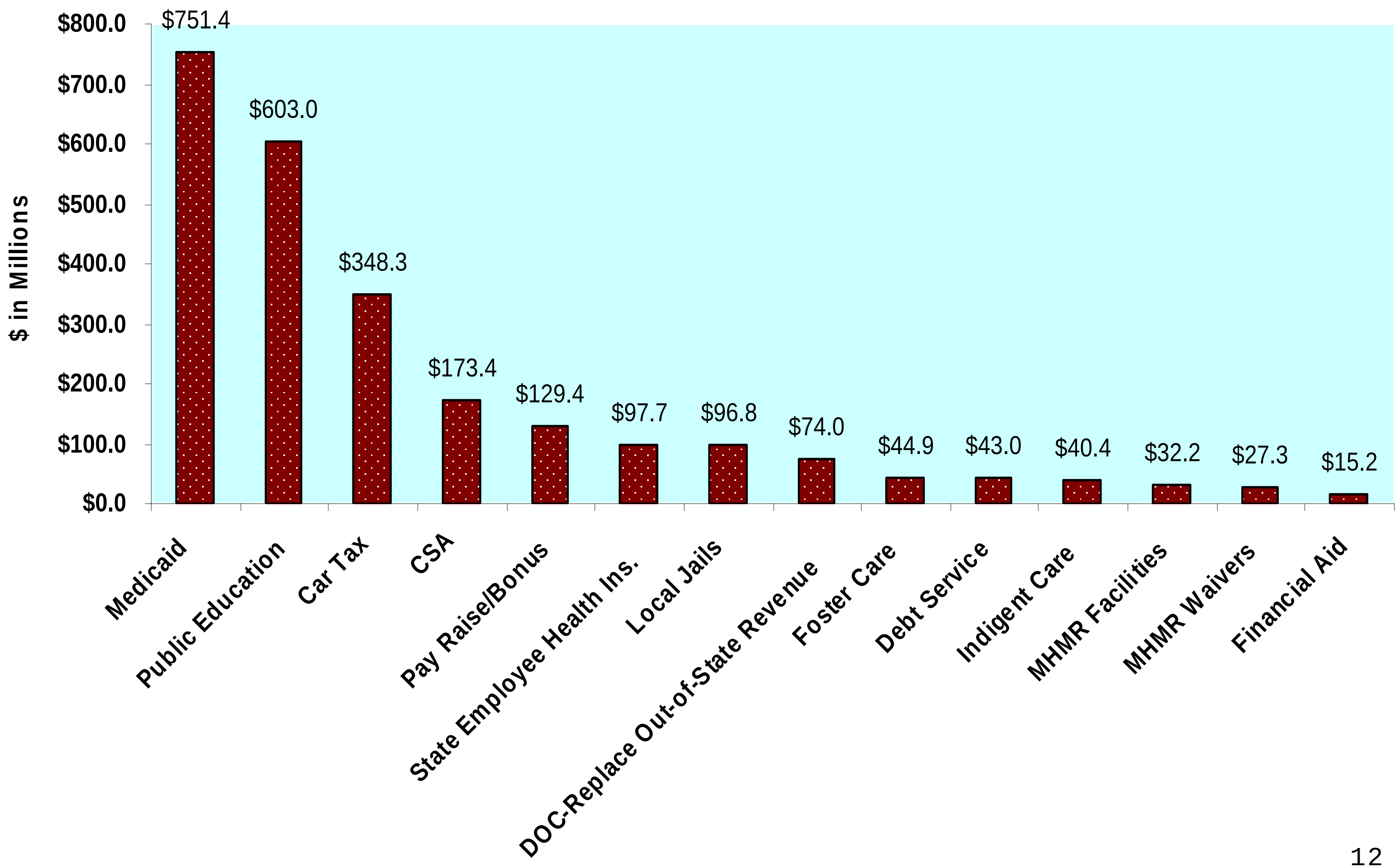
- Combination of insufficient revenues and spending pressures resulted in:
  - FY 2003 shortfall = $2.3 billion
  - FY 2004 shortfall = $2.1 billion

- Major statutory or mandatory spending requirements needed to be addressed including:
  - $751 million for Medicaid
  - $603 million for K-12 public education

- Other spending requirements reflect growing service populations or caseloads
  - $96.8 million for local and regional jails
  - $74 million to replace out-of-state prisoner revenue to meet the growing state-responsible inmate population
  - $44.9 million for foster care
  - $27.3 million for MHMR waivers

Major Spending Pressures in 2002-2004 Budget

Increases Totaled $2,477 Billion



Closing the Budget Gap 2002 and 2003 Sessions

Reductions to Close Budget Gap

- A number of actions were approved in 2002 and 2003 to bring agency budgets in line with revenues
  - Reduced agency budgets an average of about 8 percent in 2002 and another 11 percent in 2003
    - Eliminated about 5,000 positions resulting in about 1,800 layoffs
- Merged selected agencies and eliminated commissions and boards
- Implemented statewide technology and procurement reforms to generate operating efficiencies
  - VITA (technology)
  - eVa (procurement)
- Nongeneral fund transfers
- Fee increases
- Use Rainy Day Fund balances
- VRS rate adjustments
- Supplant general funds with non general funds

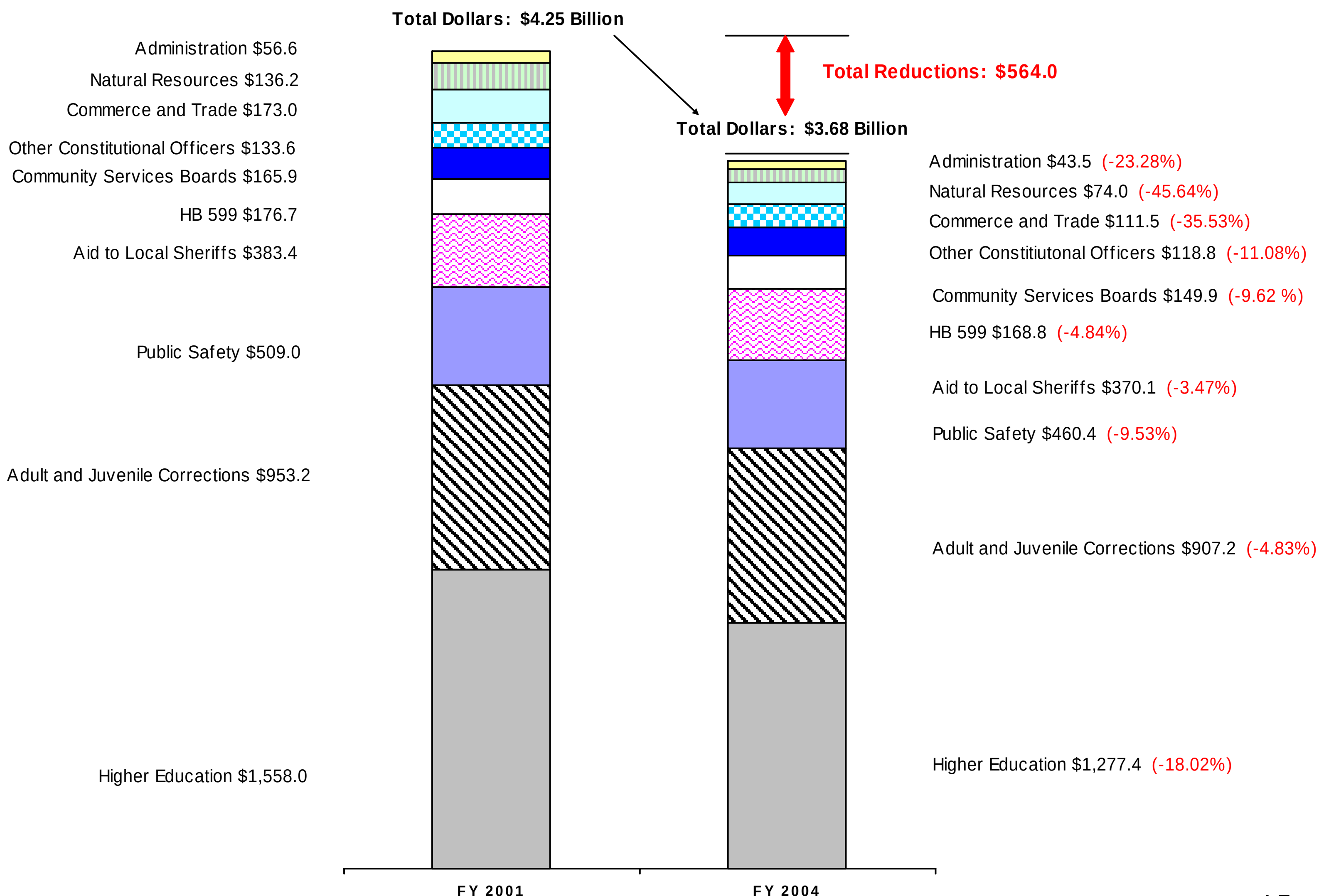
2002-2004 Budget

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)

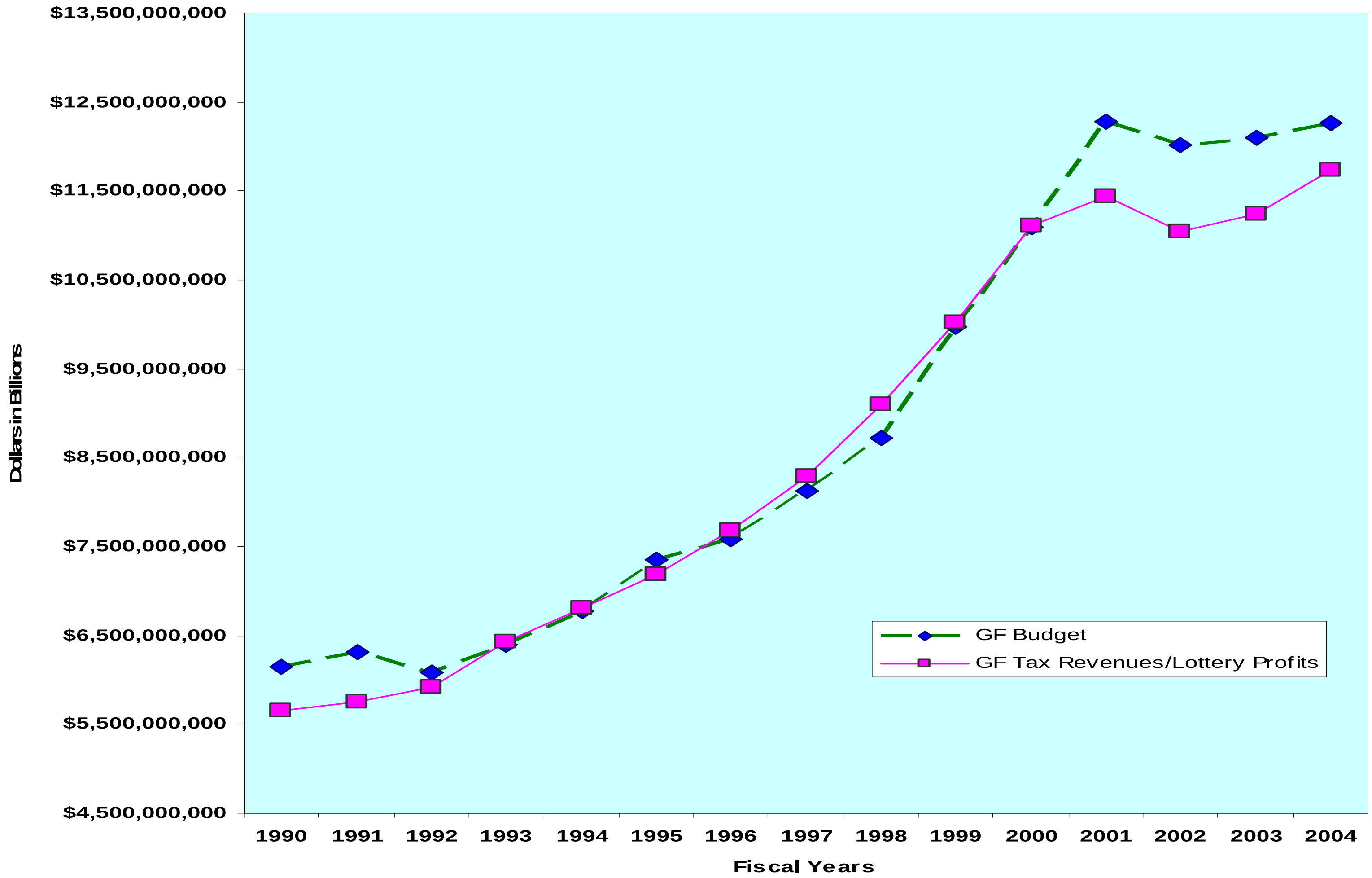


Use of One-time Actions 2002-2004 Budget

- The 2002 and 2002-04 budgets used one-time actions to help “manage” the problem
  - The use of one-time actions in FY 2004 created 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, these two budgets contained 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
- During the 1990’s recession, one-time actions also were 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 for the 2004-2006 Biennium

- What does it cost to keep doing what we are doing?
  - Base budget: $12.3 billion in FY 2004
- How much are revenues anticipated to grow?
  - Forecast general fund revenue growth of 5.4 %
  - Using the baseline revenue forecast, approximately $1.8 billion in net new general fund resources were anticipated in HB 30 after base budget adjustments
- What are the known budget drivers?
  - K-12 education
  - Medicaid
  - Corrections and public safety

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
- Required “Rainy Day” fund deposit in FY 2006 - $87.0 million
- Debt Service on G. O. Bonds - $50.5 million

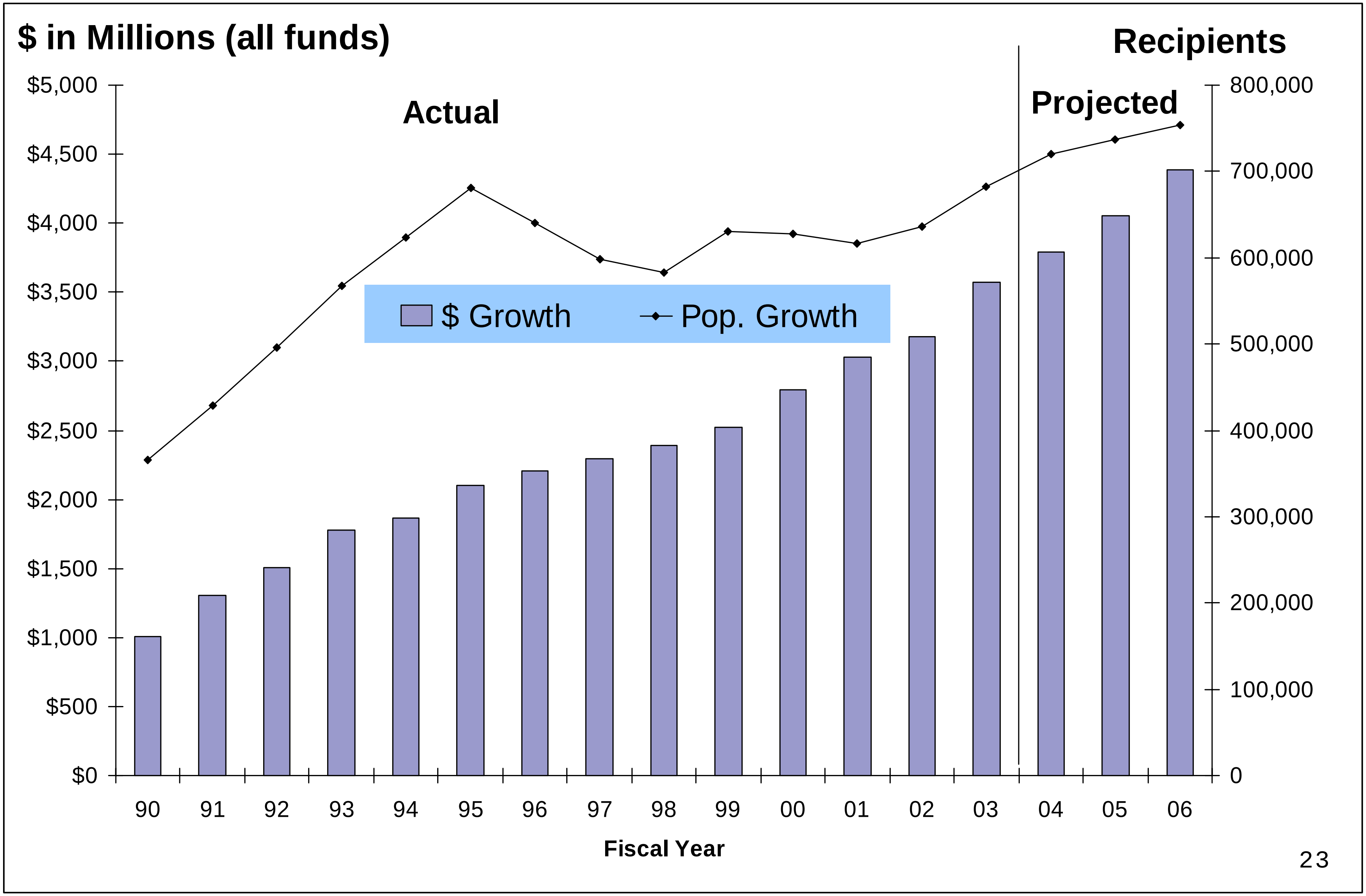
Variables Influencing Public Education Funding Growth

- Biennial SOQ rebenchmarking which reflects increases in:
  - Updating prior base-year cost for:
    - Teacher salaries and other benefits
    - Non-personal support
    - Transportation
  - Student Enrollment
    - 32,000 new students for 2004-2006 biennium
- State policy decisions
  - Revisions to SOQ
    - Board of Education recommended 9 new standards which were adopted by the 2004 General Assembly
      - Provided funding for 5 of the standards
- Federal mandates in special education services, program requirements such as the federal “No Child Left Behind” Act

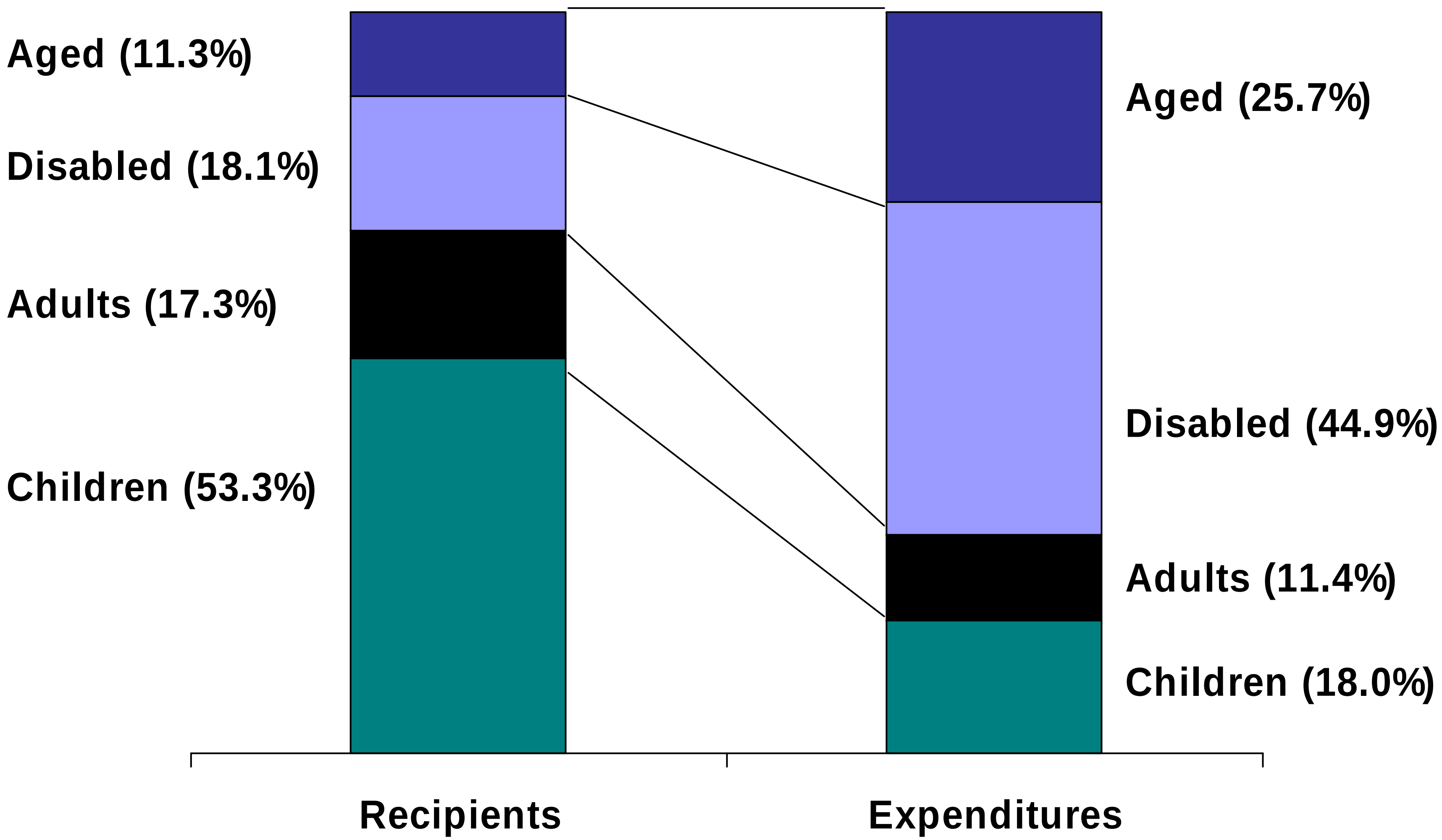
Variables Impacting Medicaid Growth

- Medical services cost inflation
  - Accounts for about one-half of the growth in the cost of the Medicaid program
- Federal mandates in the late 1980s and early 1990s added more low-income children and pregnant women to the Medicaid rolls
- State policy decisions
  - Rate increases
  - Eligibility expansions (added more low-income aged and disabled to Medicaid rolls)
  - Service expansions (mental retardation, mental health, and developmentally disabled services, among others)
- Increased costs per client
  - Complexity of care
    - Aged and disabled represent 29 percent of the Medicaid recipients accounting for 71 percent of the expenditures
  - Continued deinstitutionalization

Budget Driver: Medicaid



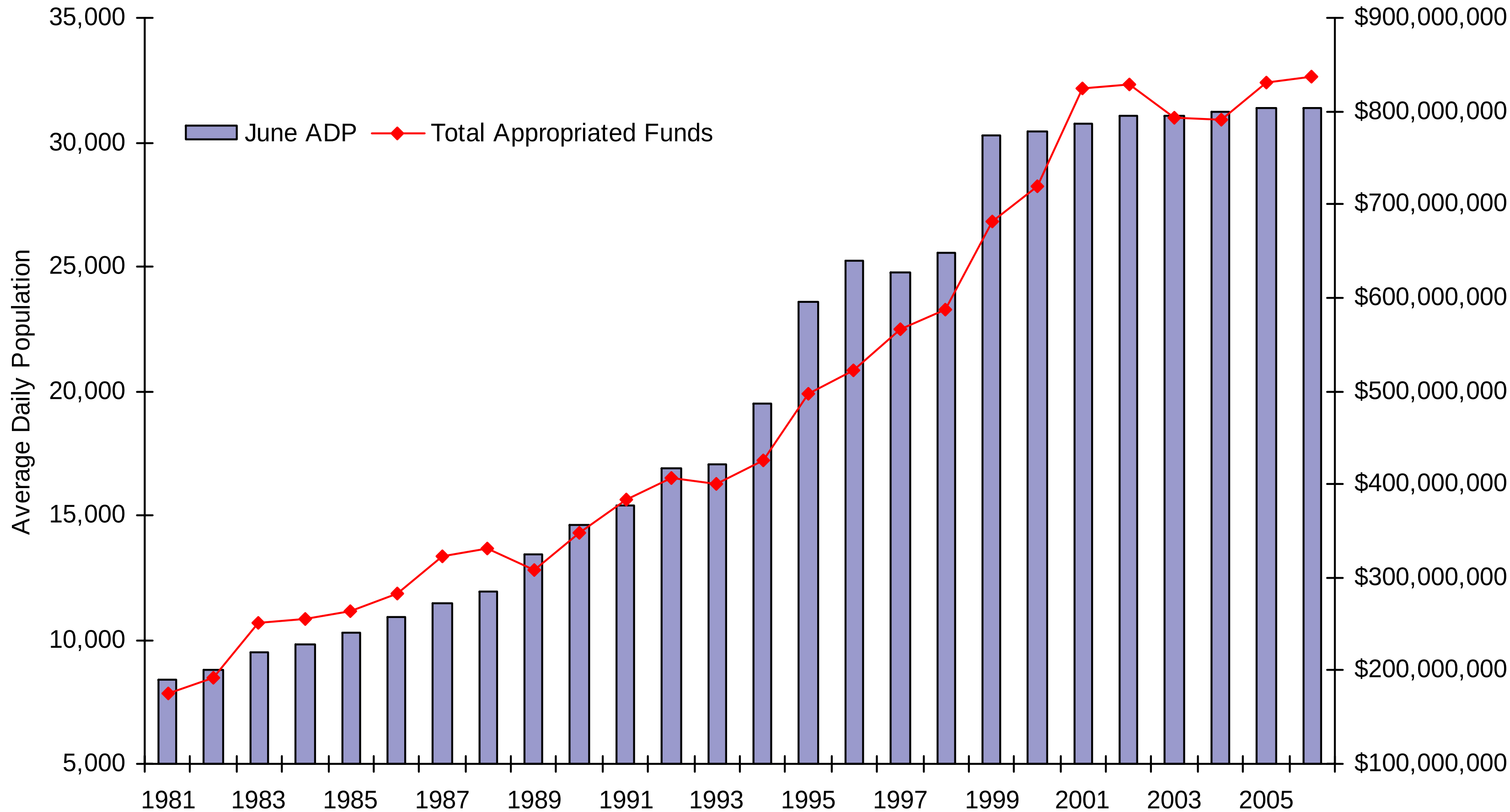
Comparison of Recipient Groups as a Percent of All Recipients and Expenditures (FY 2003)



Factors Driving Public Safety Funding Increases

- Replace out-of-state prisoner revenue
  - During late 1990s, Virginia had surplus of beds that could be filled by federal and out-of-state prisoners
    - These beds currently required for Virginia inmates in local jails
  - Number of factors driving need for prison beds
    - Longer sentences
    - Low parole grant rate for eligible inmates
    - Probation violators
  - State-responsible offender forecast projects growth of 4.1% annually through FY 2009
    - New DOC facilities required to meet forecast
- Operating and staffing local jails
  - State funds per diem payments and staff salaries through the State Compensation Board
    - Additional staff to operate overcrowded jails in a secure manner and new jails that will come on line this biennium
  - Local responsible offender forecast projects growth of 4.5% annually through FY 2009
- Additional deputy sheriffs required to meet population growth in Virginia
  - 1:1500 ratio

Budget Driver: State Corrections' Inmate Population Growth



Note: FY 2005 and FY 2006 capacity levels are estimated and do not include new facilities approved by 2004 General Assembly

What Did It All Mean?

- Based on the outlook, mandatory spending requirements consume all available 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 2004-2006 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 to be available above the base budget
  - Net new spending totaled approximately $3.0 billion

- Remaining budget gap was approximately $1,167.9 million

  - Governor's tax proposal generated approximately $1,177.1 billion

HB 30 (as introduced) 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**

2004-2006 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 additional spending 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, increases 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 share 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
  - CY 2006 payments made beginning July 1, 2006

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:
- Public Education: $1.8 billion
  - $1.2 billion for biennial re-benchmarking
  - $367.4 million to address 5 of the 9 SOQ standards adopted by the General Assembly
    - Annualized cost $241.0 million
  - Quarter-cent (HB 5018) split half for school age population and half distributed through the SOQ
  - Mitigate pressure on local property taxes
- 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
- Rebuild the Rainy Day Fund: $87.0 million "supplemental" deposit
  - Expected balance should exceed $430 million by end of biennium
    - Does not reflect additional deposit resulting from Fiscal Year 2004 surplus
- New investment in community based services for MHMR/Disabled
  - 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
- Provide structural balance to the budget
  - Triple A bond rating maintained

Fiscal Year 2004 Revenue Collections

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

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 General Fund Revenue Collections

- FY 2004 tax collections from major sources grew 9.7 percent over FY 2003
  - 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 exceed 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 spurring growth
    - 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 is the FY 2004 Surplus?

- Based on preliminary year end close data, FY 2004 annual growth rate exceeded the official forecast by 2.5 percent
  - General fund revenue surplus is $323.8 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 ($147.5 million)
  - 25 percent "super" deposit required by Code ($30.2 million)
    - Legislation adopted in 2003
    - Governor required to submit a budget amendment to 2005 Session making the deposit
- Water Quality Improvement Fund ($32.4 million)
  - 10 percent of the surplus
- Personal exemption
  - HB 5018 requires the implementation of the personal exemption increase effective January 1, 2005 ($800 - $900)
- Maintenance reserve ($40.0 million)
  - 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 ($26.0 million)
  - Actual costs are expected to be $25 to $30 million greater than projected during 2004 Session

- Only $13.8 million unencumbered, not including personal exemption

2005 Session Budget Issues

Restraint Should be The Rule

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
- 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 state employee 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
  - Staffing and operating costs of new DOC facilities and local jails approved during 2004 Session