# Budget Outlook: 2008 Session

November 13, 2007

House Appropriations Committee Retreat

# 2008 Session Budget Outlook

- A Look at Fiscal Year 2007
  - What drove the shortfall?
- Revised Economic Outlook
  - The Nation
  - Virginia
- Economic Trends Impacting GF Revenues
  - Housing market
  - Consumer confidence
- Revised Revenue Outlook for Fiscal Years 2008-2010
- 2008 Session:  Building the FY 2008-2010 Budget
  - What are the spending pressures?
  - FY 2009 is the issue

# A Look at Fiscal Year 2007

What drove the shortfall?

# Fiscal Year 2007 In Review

- FY 2007 tax collections grew 4.9%
  - However, the forecast assumed 6.5% growth
  - Total GF revenue collections were $234.4 million below the forecast
    - Payroll withholding and nonwithholding taxes performed slightly better than the forecast
      - Due to refund activity, net income taxes missed mark
    - Sales and Corporate taxes underperformed slightly
    - Recordation performed slightly better than anticipated
      - December 2006 forecast was adjusted downward to reflect the softness in housing

# What Accounted for the FY 2007 Shortfall?

- National economy performed as expected
- Virginia economy did not
  - First time in 11 years that Virginia underperformed the nation in job growth
- Forecasting issues
  - Nonwithholding revenue growth was overstated and does not reflect extraordinary refund activity among estimated payers
  - Interest Earnings forecast failed to exclude Rainy Day Fund interest from the general fund
    - After correcting for this error, GF interest earnings were $57.5 million below forecast in FY 2007
  - Underestimation of Tax Policy Changes
    - Land Preservation Tax Credit – Underestimated use of these trade-able credits. Increased refunds by $75 million above forecast in FY 2007
    - Expansion of Low Income Tax Credit – Underestimated by $33 million

# Summary of FY 07 Revenue Collections (millions of dollars)

| Major Source | Forecast | Actual | Variance Dollars | Variance Percent | Annual Growth |
|---|---|---|---|---|---|
| Withholding | $ 8,517.5 | $ 8,576.8 | $ 59.3 | 0.7 % | 6.4 % |
| Nonwithholding | 2,788.4 | 2,840.1 | 51.7 | 1.9 | 12.2 |
| Refunds | 1,337.1 | 1,559.8 | 222.7 | 16.7 | 21.6 |
| Net individual | 9,968.8 | 9,857.0 | (111.8) | (1.1) | 5.9 |
| Sales | 3,092.9 | 3,049.1 | (43.8) | (1.4) | 8.4 |
| Corporate | 901.4 | 889.9 | (11.5) | (1.3) | 2.1 |
| Wills (Recordation) | 554.4 | 582.9 | 28.5 | 5.1 | ( 16.1) |
| Insurance | 384.6 | 384.9 | 0.3 | 0.1 | 3.0 |
| All Other Revenue | 898.1 | 801.9 | (96.2) | (10.7) | 3.7 |
| **Total Revenues** | **$ 15,800.2** | **$ 15,565.8** | **$ (234.4)** | **(1.5) %** | **4.9 %** |

# FY 2007 Shortfall Led to August Reforecast

- Section 2.2-1503.3 of the *Code of Virginia* requires a re-estimate of general fund revenues if the collections of net individual, sales and corporate income taxes are 1.0 percent or more below the Official forecast
  - The FY 2007 shortfall exceeded the $139.6 million threshold
- The Governor convened the Governor's Advisory Board of Economists (GABE) to develop the August 2007 interim forecast
  - Governor's Advisory Board of Economists (GABE) consists of 15 private and public sector economists who review the economic assumptions and methodology
  - Global Insight's May economic model was used for the national forecast
  - The Virginia forecast is driven primarily by the national economic outlook
  - Virginia economic model adjusts Global Insight's model to incorporate Virginia-specific data and also reflects any recommended adjustments suggested by GABE and GACRE
- August reforecast produced an estimate for FY 2008 that is $406.7 million below that which was assumed in Chapter 847
- Combined with the $234 million shortfall in FY 2007, this produced the estimated FY 2008 gap of $641 million announced by Governor in August

# FY 2007 Shortfall Led to August Reforecast

| **August Forecast** | **FY08** |
|---|---|
| Withholding | 34.7 |
| Nonwithholding | 125.7 |
| Refunds | -282.0 |
| Sales | -119.1 |
| Corporate | -68.7 |
| Recordation | -24.4 |
| Insurance | -15.0 |
| All Other | -57.8 |
| **Total GF Revenue** | **-406.7** |
| % of Official Forecast | 2.5% |

# Economic Outlook for FYs 2008-2010

The Nation and Virginia

# Economic Outlook

## A Look at the Nation

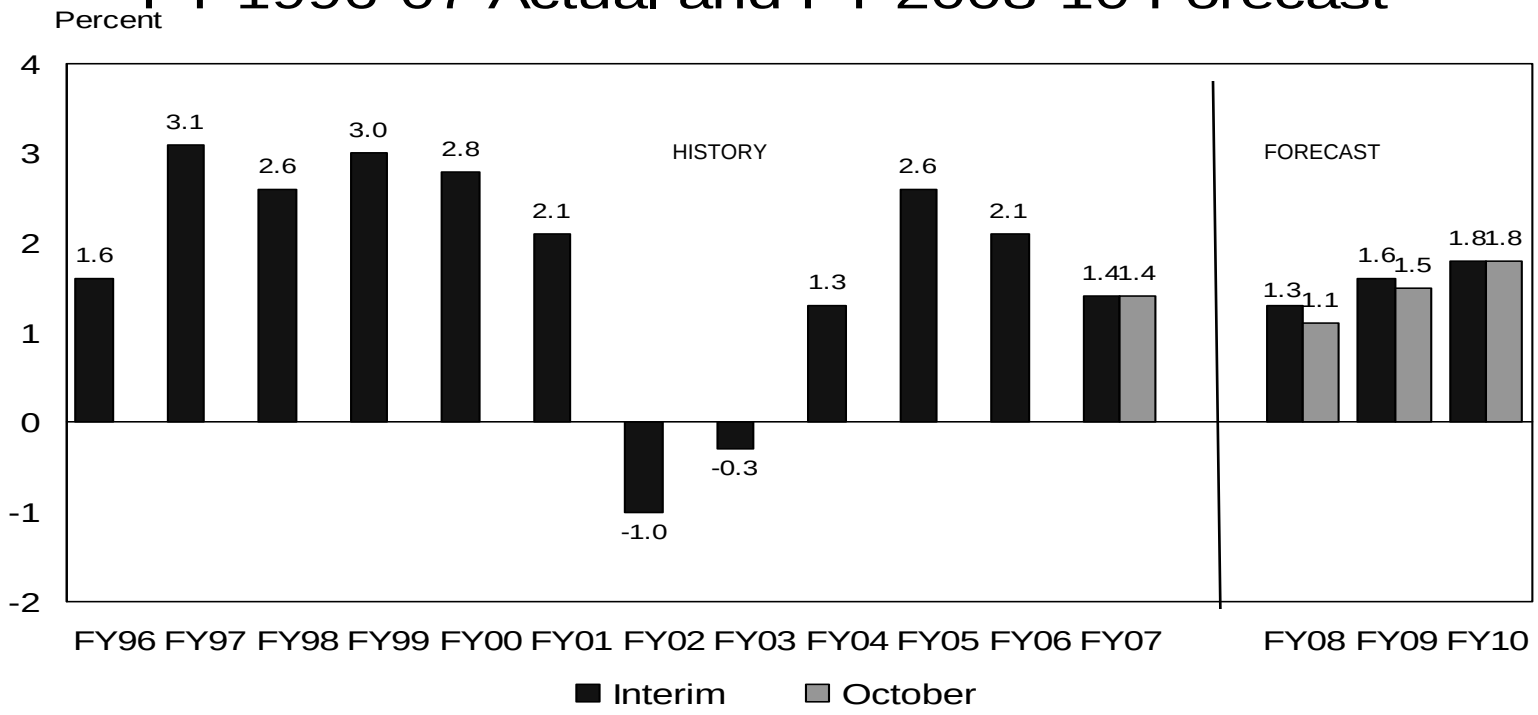
- According to Global Insight, the U.S. economy continues to expand, although it has shifted into a period of slower growth
  - Generally, the revised economic outlook is consistent with the August 2007 forecast revision
  - Payroll employment is expected to grow, albeit at below trendline pace
  - Downward adjustments reflect the downturn in housing, slowed consumer spending and employment growth
- Several positive and negative factors are in play:
  - Housing/credit crunch will continue to dampen growth in construction employment and housing-related purchases (building materials, furnishings)
  - Consumer spending will grow at a much slower rate following years of spending increases exceeding increases in personal income
    - Home equity withdrawal had fueled consumer spending
    - Credit crunch extends beyond mortgage market
  - Stock market gains will prop up nonwithholding revenues
  - Dollar's low value is resulting in big increases in exports

# Virginia's Economic Outlook in Fiscal Years 2009 through 2010

- Outlook projects that Virginia will again out-pace the nation in job, personal income, and wage and salary growth
  - The revised forecast should reflect small changes in wages and salaries from the official forecast issued in August 2007
    - Wage and salary growth is expected to remain strong due to the concentration of high paid jobs (Professional and Business Services) being created in NoVA
    - Payroll withholding will be aided through strong wage and salary growth, which will help offset weaker employment growth
- Employment growth moderated in FY 2007. The outlook suggests job growth to be below 2% over the forecast horizon
  - NoVA job growth is expected to lead the state, albeit at a slower rate
    - Slower federal spending and low unemployment rate will restrain job growth to between 2 – 3 percent
  - Business and professional services jobs continue to lead in the "crescent"
  - Manufacturing is expected to see further declines

# Virginia Employment Growth

## FY 1996-07 Actual and FY 2008-10 Forecast

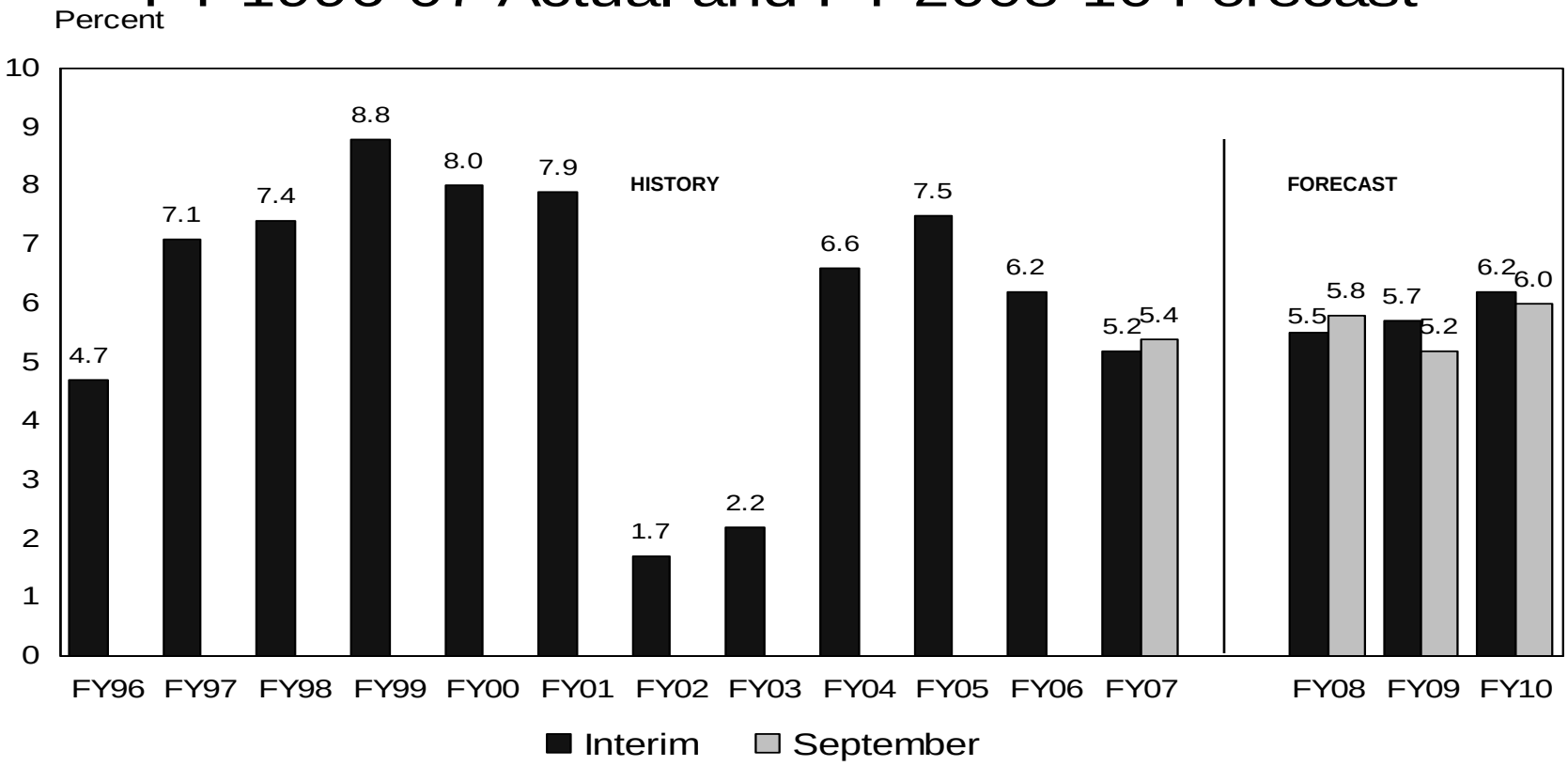



| Actual Job Gains | Forecast Job Gains |
|---|---|
| FY05 +91,600 | FY08 +48,754 |
| FY06 +76,200 | FY09 +56,986 |
| FY07 +45,567 | FY10 +69,409 |

Job growth expected to be below long-trend average of 1.7 percent

# Virginia Wages and Salaries Growth

## FY 1996-07 Actual and FY 2008-10 Forecast

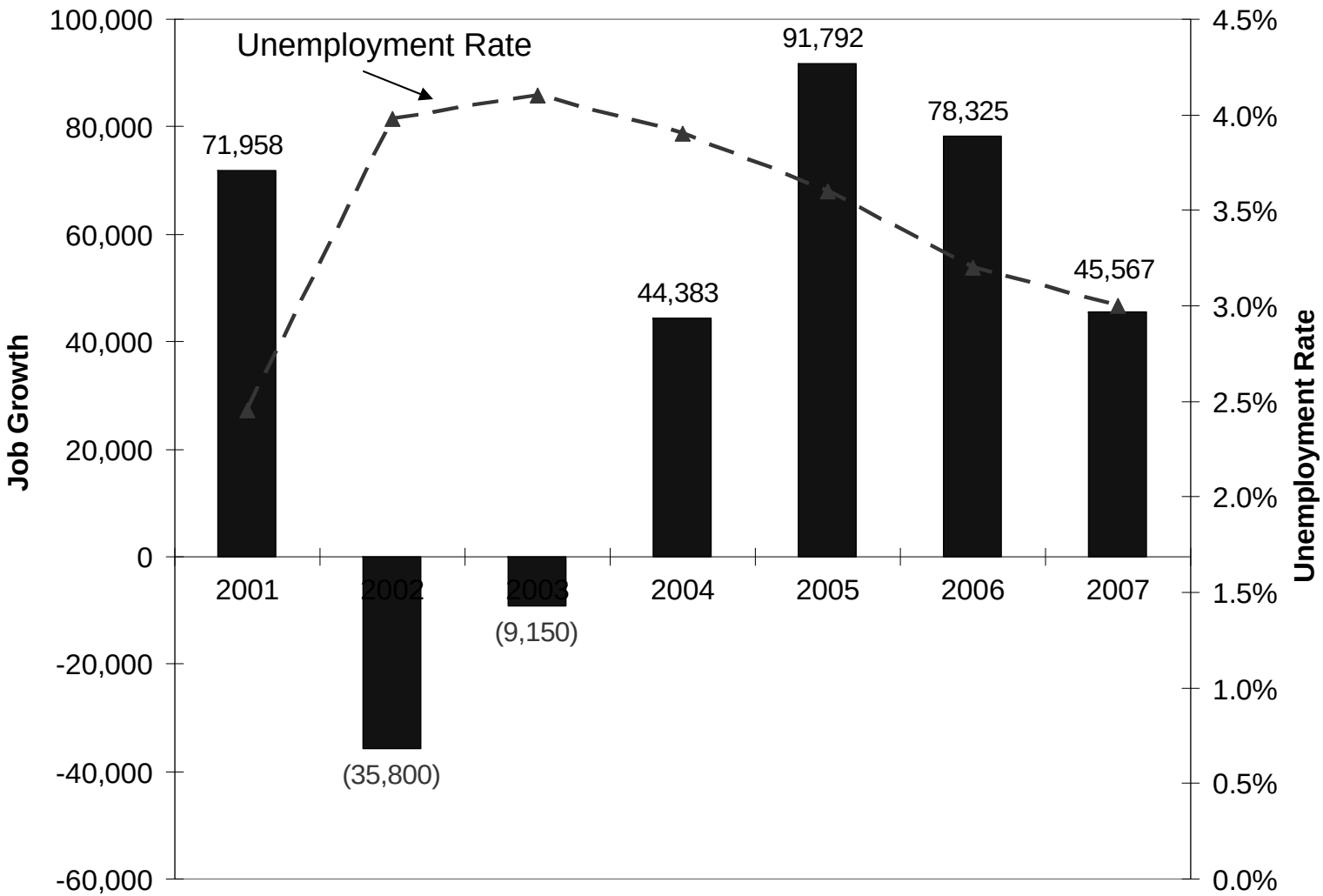



- Average wages are expected to increase an average of 4.1% per year through the forecast horizon
- Growth mirrors long-term trend average

# Why is Employment Growth Slowing?

- Virginia has lowest unemployment rate of any state with over a million people - now facing shortage in workers, not jobs in major urban areas
- Statewide housing slump is affecting employment in certain sectors
  - Construction employment is expected to decline for a second year in a row in FY 2008
    - Falling 1.0% for the year
  - Employment in financial activities is projected to increase 0.6% in FY08
    - Significantly below historical trend growth of 2.0%
- NoVa Employment Slowing Down
  - Region has accounted for over 60 percent of the state's job growth since 2003
  - Employment growth has been driven by federal spending
    - Growth in federal spending has tapered off from the double-digit growth rates earlier in decade
  - Region's unemployment rate is at 2.1%
- The high-paying professional and business services jobs are projected to increase 3.3 percent in FY 2008
  - Down slightly from historical trends
  - Important to economy because highly paid
  - Sector accounted for 35 percent of job growth since 2003

# Job Growth and Unemployment Rates
# Fiscal Year 2001 – 2007



# Northern Virginia and the Federal Government

- Federal procurement spending has been the biggest gainer among the major sources of federal spending since 1996
  - Gains have been greatest since 9/11
  - Nationwide, 16 cents of every federal procurement dollar is spent in the Washington MSA
    - Up from 4 cents in 1983
- Federal spending constitutes 35 percent of the region's economy (payroll and procurement)
  - Procurement spending represents nearly 50 percent of total federal spending
  - 78 percent of the contracts are in the service industry – high wage jobs like data processing, telecom services, professional and managerial support
  - Average annual growth rate was 16.5% from 2001 through 2004

# Federal Spending is Starting to Slow

- According to the Center for Regional Analysis at George Mason University, nearly 7,000 jobs are created for every $1.0 billion in federal procurement spending
  - Estimated that approximately 50 percent of all new jobs in DC area tied to federal procurement
- Preliminary data indicates that federal procurement spending increased only about 3.0 percent each in 2005 and 2006
  - Down from the 19 percent gain in FY 2004

# Near Term Outlook for Northern Virginia

- Continued deceleration in federal spending will dampen employment growth in the region
  - NoVa accounts for nearly 60 percent of the Metro employment growth
- Prior year federal monies are still being spent
  - Pig in the python
- Overall, employment is expected to grow at or slightly less than 3 percent, below the 3.5 - 4.0 percent growth rates seen over the last 3 fiscal years

# Economic Trends Impacting GF Revenues

# Economic Trends Impacting GF Revenues

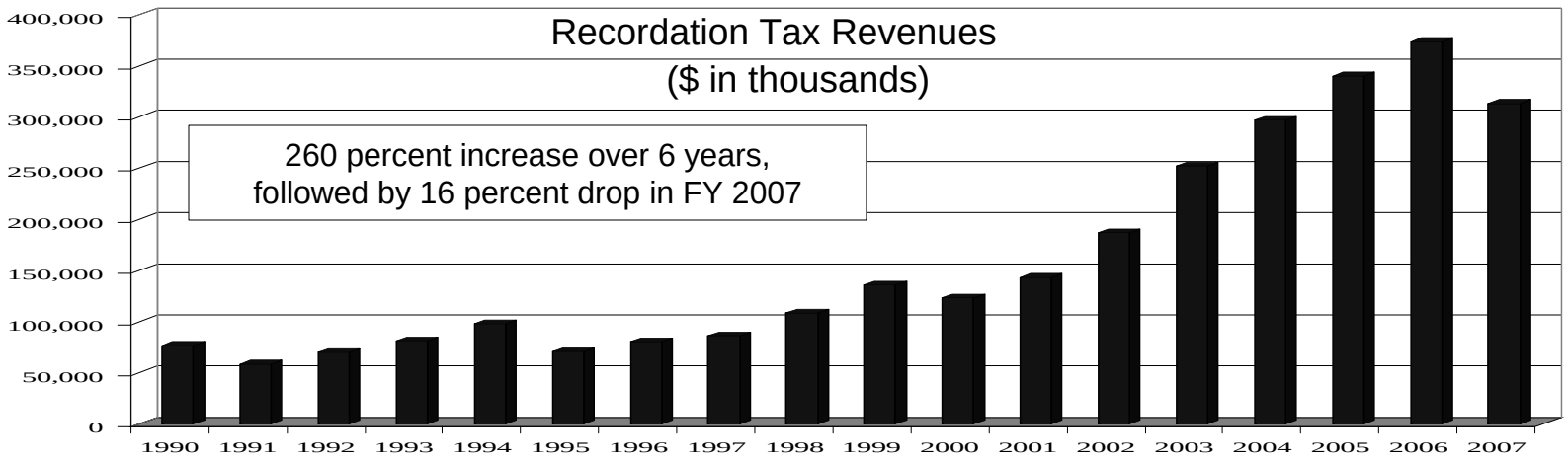
- There are two major trends impacting economic growth
  - Housing slump
  - Increasing energy prices
- The broader impacts of these two factors on the economy can be seen in consumer confidence, which has declined in recent months
  - The Conference Board Consumer Confidence Index fell in October, continuing its 3-month decline and hovering at a 2-year low
    - The Index now stands at 95.6 (1985=100), down from 99.5 in September
  - The November University of Michigan Consumer Sentiment Survey showed an even more precipitous decline with overall sentiment falling to 75.0 (1966=100)
  - This has led to a reduction in consumer spending, with U. S. retailers reporting their worst October sales in 12 years

# Housing Market Downturn Has Slowed Revenue Growth

- Last December's GF forecast assumed substantial revenue reductions based on the housing slowdown
  - Recordation revenue forecast pulled down 20% in FY 2007
  - Explicit downward adjustment made to sales tax to reflect declining home improvement and furnishings purchases
- Continued slowdown in housing-related economic activity which will constrain growth of three core GF revenue sources:
  - Recordation taxes
  - Corporate/Nonwithholding
  - Sales Tax

# Recordation Taxes
## Major Source of Revenue Growth through FY 2006

- Recordation taxes were a minor general fund revenue source prior to 2000
  - In FY 2000, they comprised only 1.1% of GF revenues -- $123 million
- Over the next 6 years, recordation tax collections (exclusive of tax increase) grew 260% and accounted for 20% of all general fund revenue growth between 2000 and 2006
  - From FY 2001 through FY 2006, recordation tax receipts grew an average of 21% annually
- Inclusive of the tax increase, recordation revenues totaled $622.5 million and comprised almost 5% of GF revenues in FY 2006
- In FY 2007, recordation tax collections fell 16%
  - Revenue forecast had been adjusted to reflect an even larger decline of 20% -- exceeded the FY 2007 forecast by $28.5 million



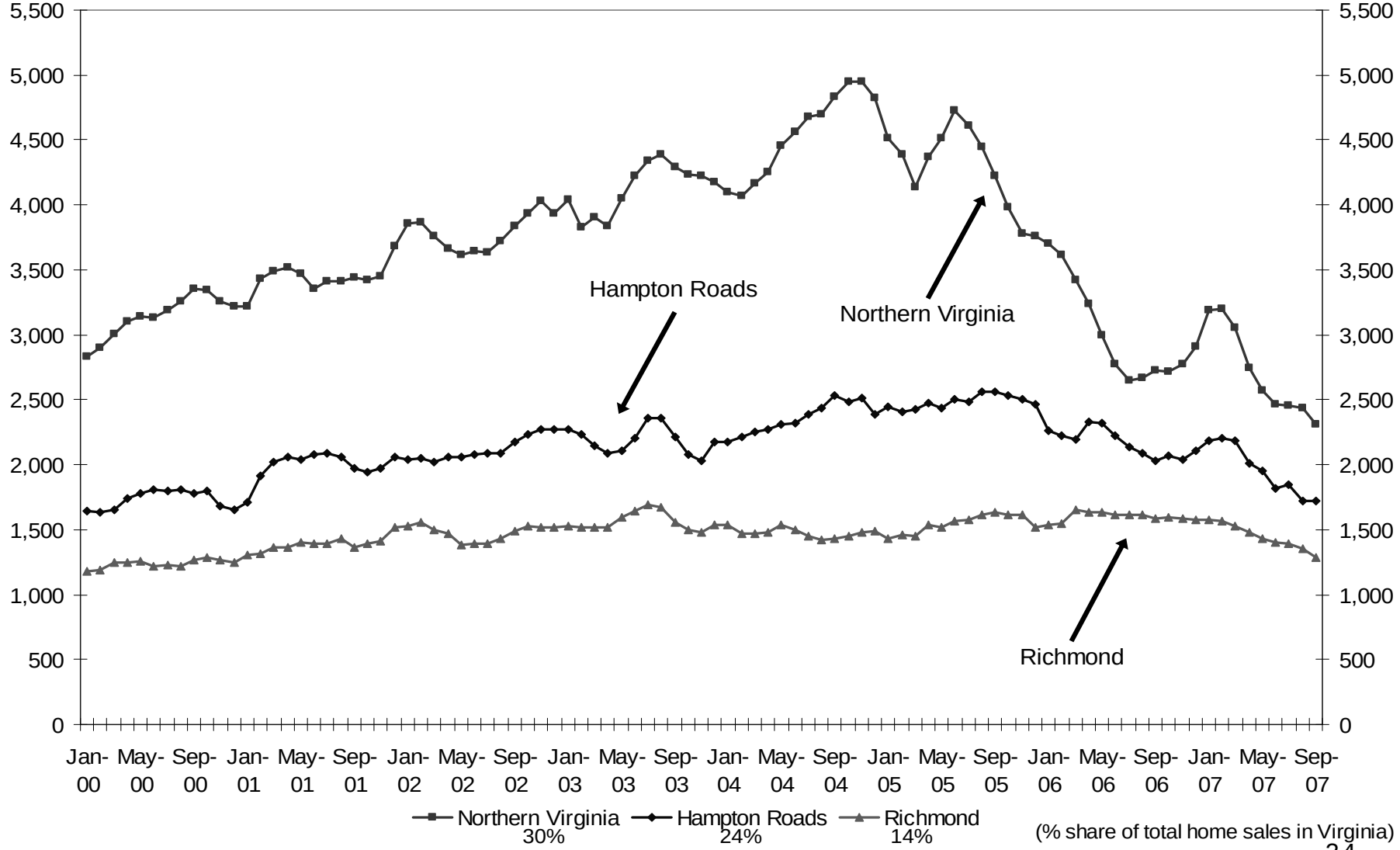
# What Drives Recordation Tax Revenues?

- Recordation tax collections are driven by three factors:
  - Homes sales
  - Price appreciation
  - Refinancings
- Recent slump in recordation taxes – and housing market overall – has been driven primarily by declining sales volume
  - The seasonally-adjusted, 3-month moving average of home sales fell 18% in September compared to the prior year
    - Pending home sales in Northern Virginia were down 14%
  - Downturn in Northern Virginia felt earlier – sales volume in Northern Virginia is off 52% from Q3 2004
  - Northern Virginia previously accounted for 37% of home sales – now has fallen to 30% of all sales

**Pending Home Sales in Northern Virginia, Hampton Roads, and Richmond**

Levels

Seasonally-adjusted 3-month moving average




(% share of total home sales in Virginia)

# Recordation Revenues: Role of Price Appreciation

- In addition to historically high levels of home sales, record price appreciation drove growth in recordation revenues
- Even after adjusting for price declines in certain areas over the last 18-24 months, values are far in excess of levels seen 4-5 years ago

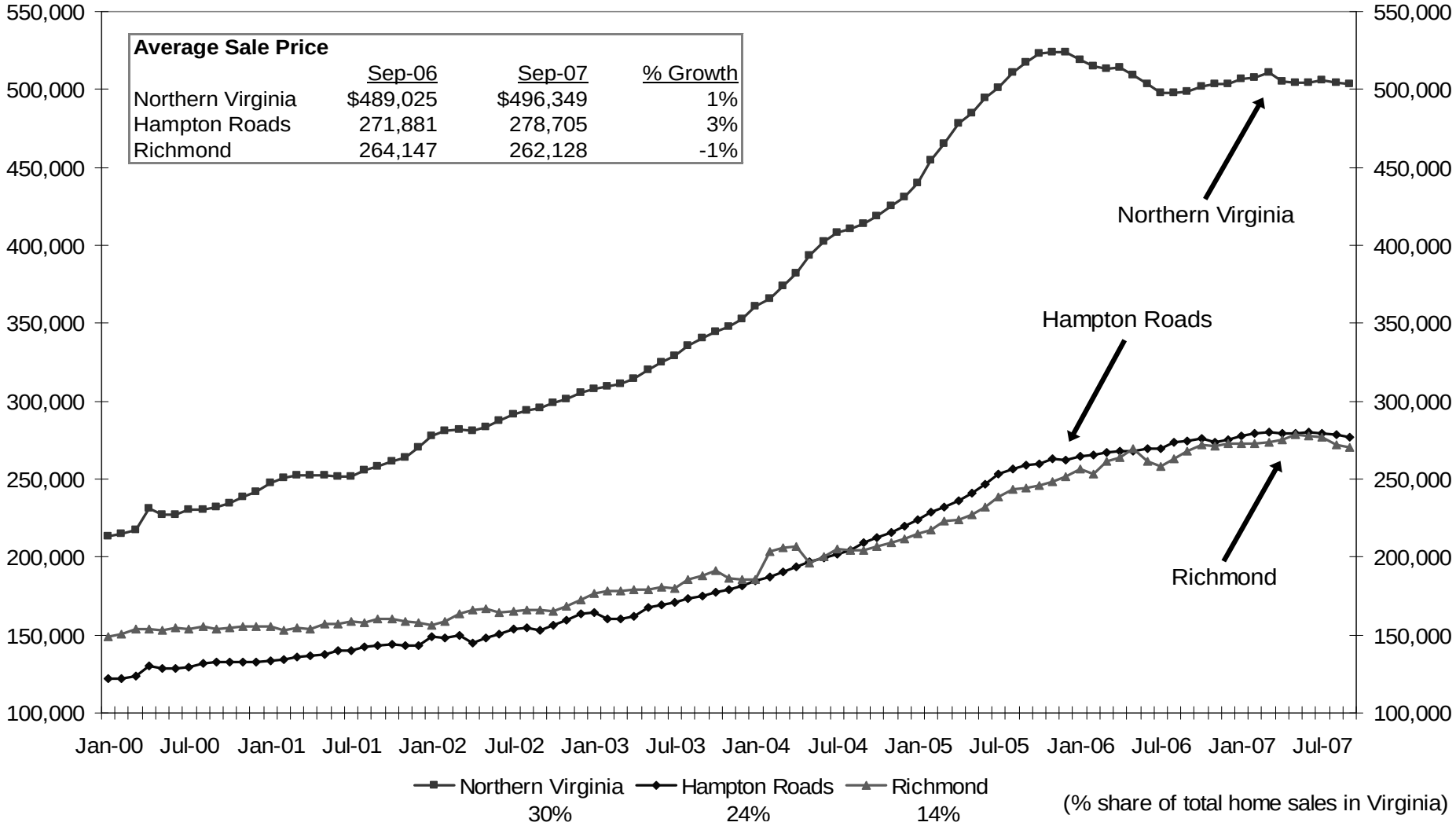
| **Average Sale Price** | | | |
|---|---|---|---|
| | Jan-03 | Sep-07 | % Growth |
| Northern Virginia | $308,918 | $496,349 | 61% |
| Hampton Roads | 157,388 | 278,705 | 77% |
| Richmond | 168,822 | 262,128 | 55% |

  - As of September, Northern Virginia prices have increased 1% year-over-year
    - But still below highest price point in November 2005 (from 524k to 496k)
  - Use of builder incentives has staved off price declines to a certain extent
    - Masks depth of actual reduction because these “savings” don’t impact sales price
  - Rule of thumb is that price declines aren’t seen until 18+ months after sales drop off
    - Are other regions still to see further price declines and of what magnitude?

**Average Sale Price in Northern Virginia, Hampton Roads, and Richmond**

Levels

Seasonally-adjusted 3-month moving average




**Average Sale Price**

| | Sep-06 | Sep-07 | % Growth |
|---|---|---|---|
| Northern Virginia | $489,025 | $496,349 | 1% |
| Hampton Roads | 271,881 | 278,705 | 3% |
| Richmond | 264,147 | 262,128 | -1% |

(% share of total home sales in Virginia)

# Change in Inventories of Existing Homes in NoVa
## (Month-Over-Year Change 2000 – 2007)

*Includes Fairfax and Arlington counties and the cities of Alexandria, Fairfax and Falls Church

Source: NVAR, MRIS, GMU Center for Regional Analysis

# Impact of Housing on Corporate Taxes

- The official forecast for FY 2008 corporate income taxes adopted last year assumed a significant increase in corporate refunds due to the slowdown in housing
- Corporate income tax collections increased just 2.1% in FY 2007, down substantially from the 32% average annual increase over the last four years
  - Impact of housing industry decline on corporate refunds occurred even sooner than anticipated – refunds in FY 2007 were more than 25% above FY 2006 levels
  - FY 2007 collections missed the forecast by $11.5 million
- The share of corporate income tax receipts attributable to the housing industry declined from 16% in FY 2006 to 8% in FY 2007
- Revised outlook for corporate income tax collections assumes further decline through FY 2009, followed by slow growth in FY 2010
  - Anticipated to decline 18.4% in FY 2008 and 1.4% in FY 2009, followed by a modest increase of 5.5% in FY 2010
- Leading home builders continue to report extremely weak quarterly results
  - As of September's report, housing permits in Virginia are down over 41% in Virginia on a year-over-year basis

# Impact of Housing on Sales Tax

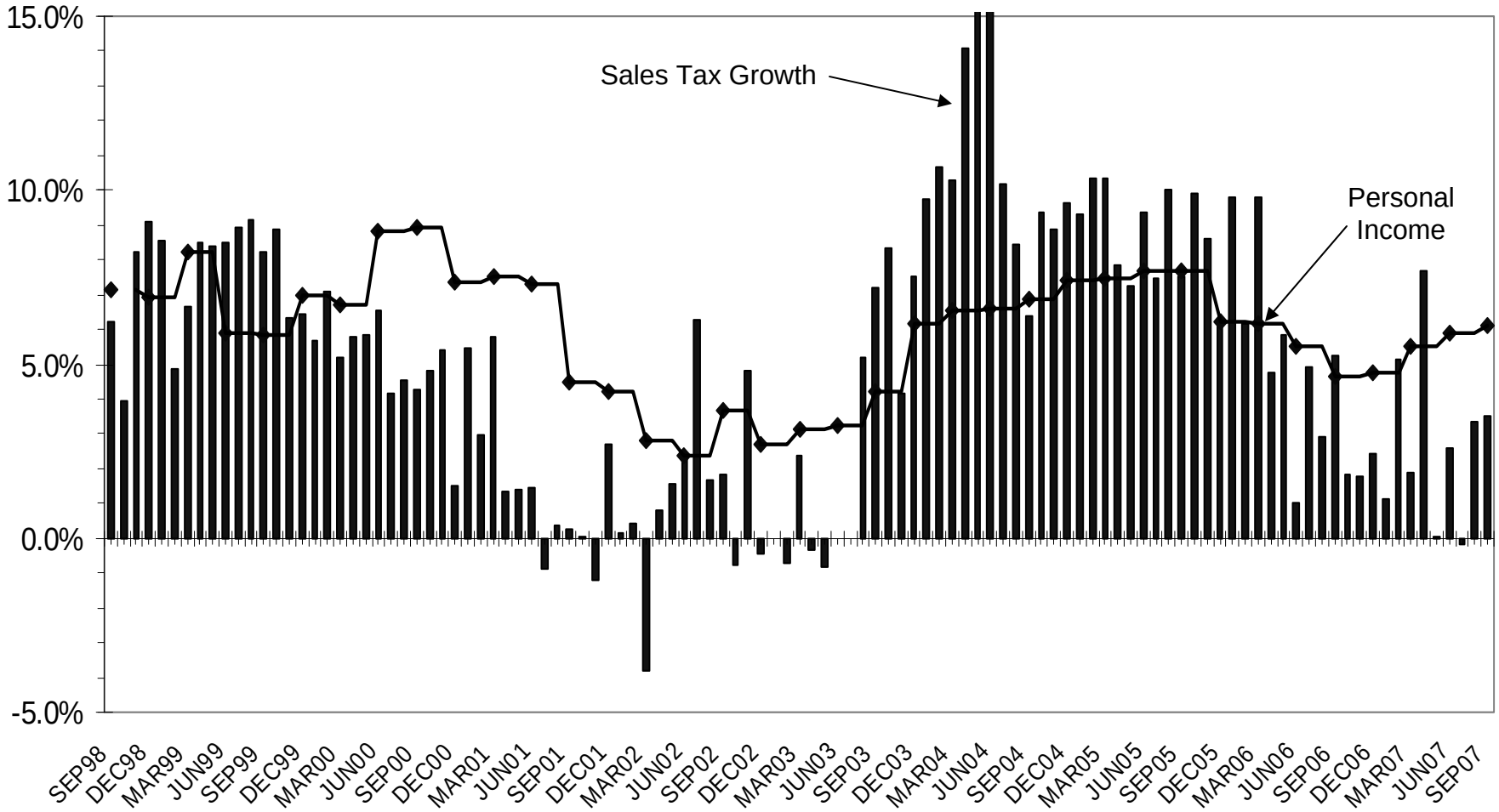
- Housing boom had substantial direct impacts on both consumer and business purchases
- Business purchases – building materials, lumber etc.
  - Building materials and supplies were the fastest growing subcategory of sales tax in both FY 2004 and FY 2005, representing almost 30% of total sales in FY 2005
  - Preliminary data indicate that in the most recent quarter, these items have fallen to only 16% of sales
- On the consumer side of the equation, home furnishings and accessories expenditures have fallen, while total retail sales continue to grow, albeit at a slower rate
  - Census Bureau reports that while total retail sales increased 5% from September 2006 to September 2007, furniture and home furnishing stores sales fell by just under 1% this past year (-0.9%)

# Indirect Effects of Housing on Sales Tax Collections

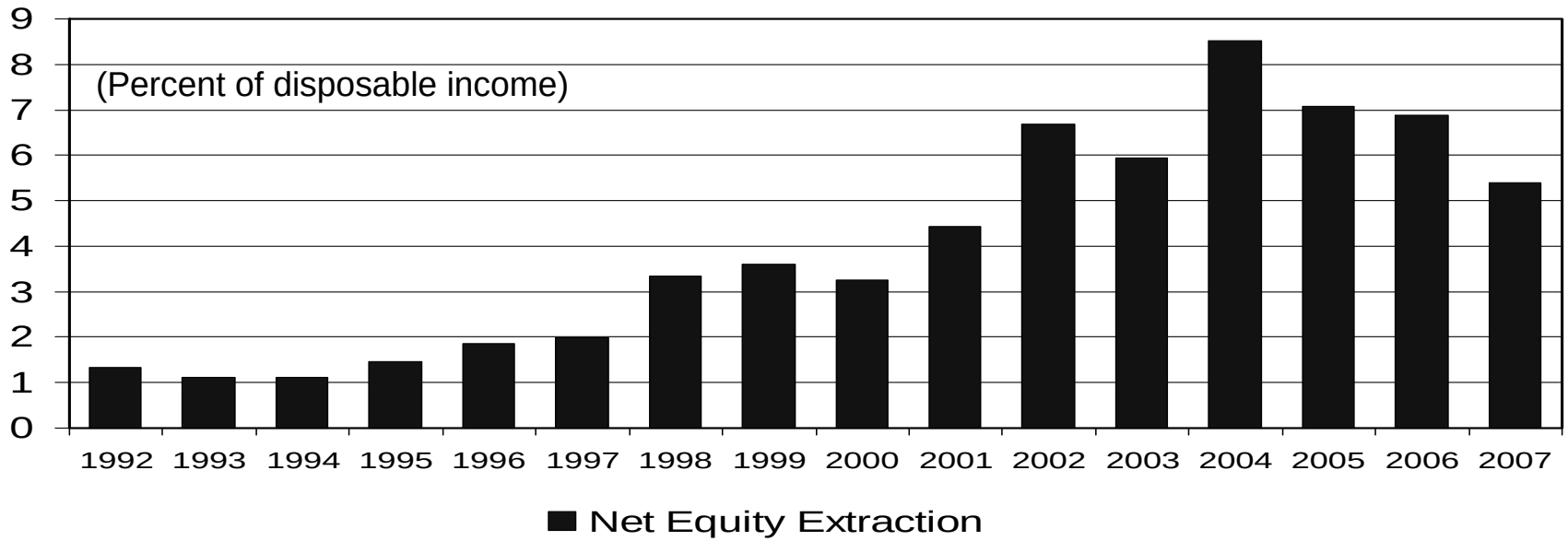
- In addition to the obvious direct impact of the housing boom on tax collections, the fast-paced price appreciation had substantial indirect impacts on the consumer side of the equation
- These effects are harder to quantify
  - “Wealth effect” of price appreciation
  - Spending based on general consumer confidence
  - Impact of cash-out refinancings

# Sales Tax and Personal Income Growth

## Three-month Moving Average of Year-over-Year Growth



# Mortgage Equity Withdrawal Has Eased




Source: Federal Reserve - Kennedy/Greenspan data updated as of September 2007

- Growth in refinancings – 75% of which are “cash-out” – had substantial impacts of consumer spending
- 51 percent of equity withdrawals are used for home improvements and other consumer expenditures
- Mortgage withdrawals accounted for close to 8 percent of disposable income and more than 4 percent of consumer spending in 2005

# Potential Revenue Impacts of Continued Housing Market Decline

- How substantial and long-lasting will the housing decline be and how will it affect the general fund revenue outlook?
- Negative Pressures:
  - Use of alternative financing sustained activity in prior years – has exceeded its limits
    - ARMs accounted for 35% of loans in 2005, interest-only loans above 25% in same year
    - Re-setting of ARM mortgages set to peak over next 6-9 months – breadth of available products dramatically restricted
  - Increases in delinquencies/foreclosures have led to tightening of mortgage market and reduced qualifications
  - Media frenzy related to the housing “story” amplifies decreases in consumer confidence

# Potential Revenue Impacts of Continued Housing Market Decline

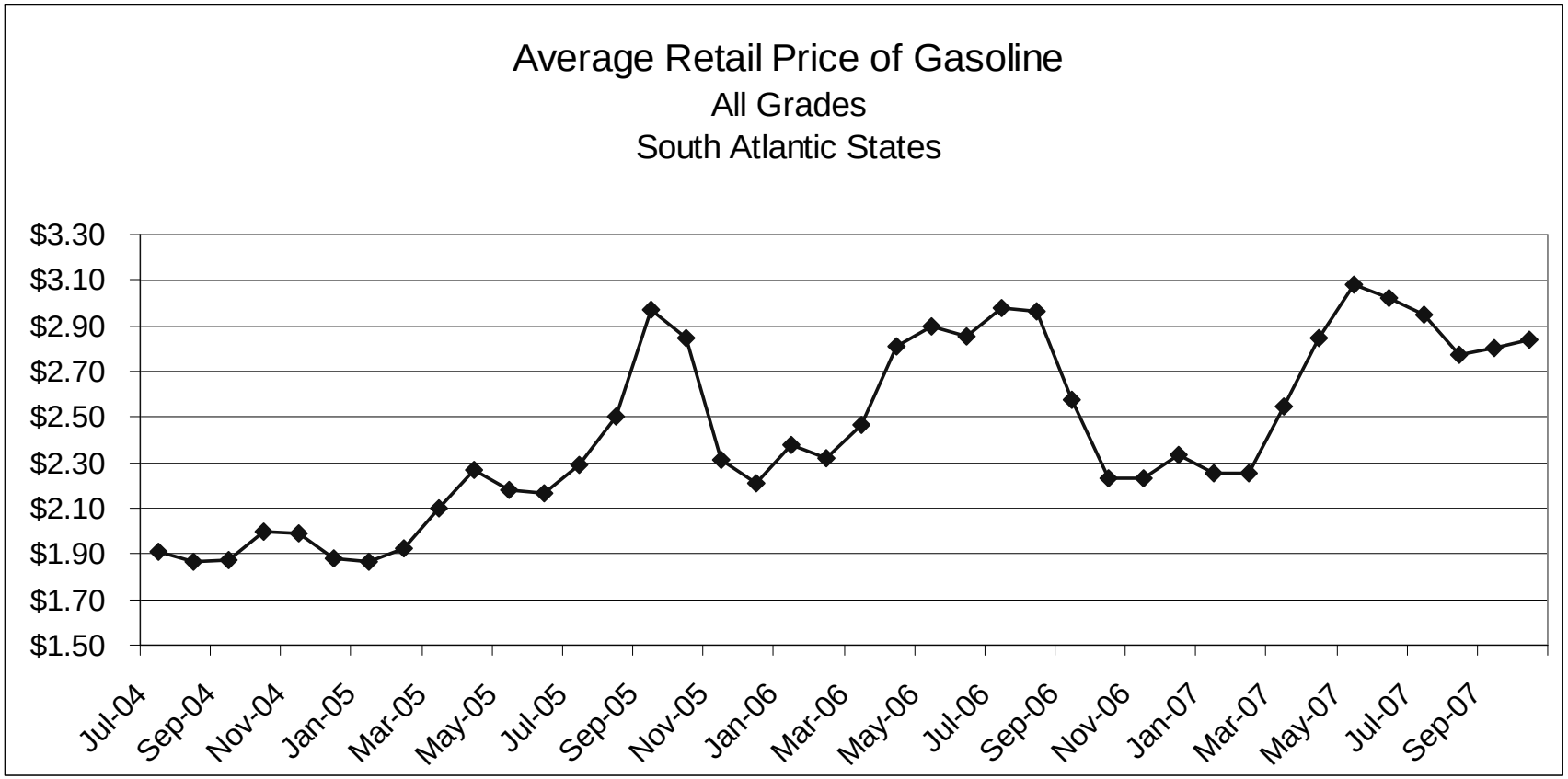
## Stabilizing Forces:

- Unlike previous housing declines, other fundamentals in economy remain strong
  - Interest rates still relatively low, not projected to spike – about 6%
    - Average rates in current decades have been: 9% in 1970s, 13% in 1980s, 8% in 1990s
    - Banking industry working to modify existing loans to offset impact of re-setting ARMs
  - However, tightening credit standards and risk premiums added to jumbos and nontraditional mortgages offset this stabilizing force
  - Job and income growth continuing albeit at slower rate on statewide basis
- Cutback in new home construction will thin out inventory – strengthening home prices in the long run
  - Housing permits have been declining for almost 2 years – already at lowest rate in decades
- FY 2008 revenue forecast already reflected declines based on the housing drop-off

# Impact of Gasoline Prices on Economy

- According to Global Insight, every 10 cent increase in gasoline prices reduces national disposable income $12.0 billion annually
  - Virginia's GDP is 2.82% of the national economy
  - Thus, every 10 cent increase in gas prices could reduce Virginia's disposable income by approximately $300-350 million
- If the 79 cent cumulative increase in gas prices over the past two years had been constant, it would have reduced Virginia's disposable income by $2.4 billion or more each year
- Crude oil prices have reached all-time highs in recent weeks – closing at almost $100/barrel
  - Expectations are that gas prices should increase to the $3.50/gallon range by Spring 2008

# Retail Gasoline Prices Have Increased Dramatically in the Last ThreeYears




Average Price of Gasoline (Source: Energy Information Administration)

July 2003 - July 2005: $1.849
August 2005 – October 2007: $2.638
79 cent increase in average price

# Summary: Impact of Housing and Gas Prices on GF Revenues

- Together, the decline in the housing sector and energy price increases have substantial indirect effects on general fund revenues
- The dramatic slowdown in housing and the sub-prime mortgage meltdown pose significant risks to continued growth
  - Reduced consumer spending based on housing wealth/equity withdrawals
  - Reduced profits in related sectors of the economy – i.e. mortgage/financials, construction sector, home furnishings
- In light of already weakening consumer confidence, increasing energy prices could further constrain growth in sales tax and related general fund sources

# General Fund Revenue Outlook

## Fiscal Years 2008 - 2010

# Revenue Forecast Process
## *Virginia Economic Indicators*

- Several economic indicators serve as proxies in measuring growth in the two largest revenue sources
  - Individual Withholding: Jobs and average wages and salaries serve as proxies
  - Sales Tax: Personal income serves as the primary proxy
    - However, it does not always capture outside influences that can impact sales tax revenues, such as "cash-out" home refinancing, and energy price increases
  - While the proxies serve as a gauge in measuring revenue growth, they don't always pick up the inflection points during an economic slowdown, recovery or expansion

| | 08 | 09 | 10 |
|---|---|---|---|
| Employment | | | |
| Interim ('07) | 1.3 | 1.6 | 1.8 |
| October ('07) | 1.1 | 1.5 | 1.8 |
| Personal Income | | | |
| Interim ('07) | 5.6 | 6.0 | 6.2 |
| October ('07) | 5.6 | 5.9 | 6.2 |
| Wages & Salaries | | | |
| Interim ('07) | 5.5 | 5.7 | 6.2 |
| October ('07) | 5.5 | 5.2 | 6.0 |
| Average Wage | | | |
| Interim ('07) | 4.1 | 4.1 | 4.3 |
| October ('07) | 4.4 | 3.7 | 4.1 |

# Revenue Forecast Process

*Forecasting is an "Art" and a "Science"*

- The remaining revenue sources do not have similar proxies, however, several factors can influence revenue collections:
  - Nonwithholding or estimated payments: This other source of personal income tax revenues falls into two general categories: small businesses/self employed and individuals with substantial investment/dividend income
    - Investment returns (i.e., stock market) have a strong correlation to nonwithholding taxes and business earnings
    - Employment growth does not adequately capture contract or self employed individuals
  - Corporate income taxes: The most volatile of major tax sources and does not lend itself to an easily discernible growth trend. Forecasting is difficult due to safe harbor rules, carry back and forward rules which allow companies to smooth out their income tax liability, and depreciation schedules
    - Corporate taxes can be a leading indicator on the economy
  - Recordation Taxes: Housing starts, interest rates and housing values
  - Public Service Corporation Taxes: Weather conditions influence consumption of power and natural gas
  - Insurance Premium Taxes: Claims experience and interest rates can impact insurance premiums

# Revised Revenue Forecast for FY 2008

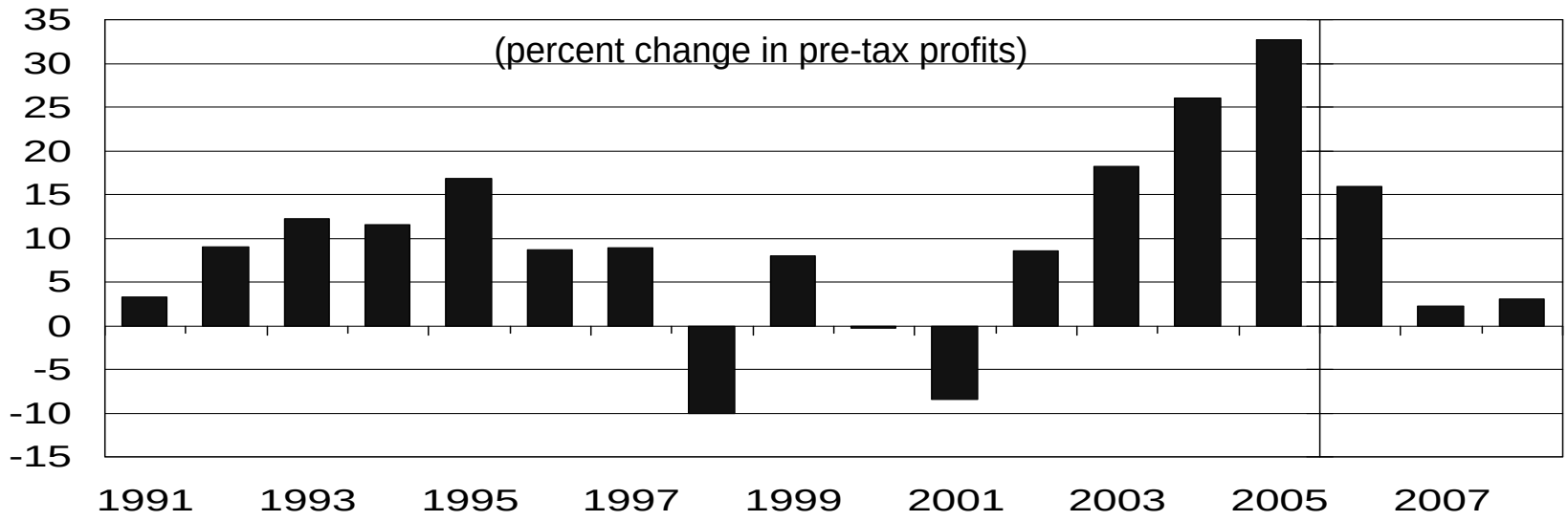
- Because less than 3 months have passed since the forecast was revised in August, we do not anticipate major revisions
- The Virginia economy is expected to grow near trend over the forecast horizon with growth in employment and income near historical averages
  - Employment growth is expected to decelerate in FY 2008 to 1.1%
  - Growth in total personal income in FY 2008 remains unchanged from the interim estimate of 5.6% growth
  - Wages and salaries growth also unchanged from interim forecast of 5.8% in FY08
- The revenue adjustments reflect actual performance for the first four months of the fiscal year and a new forecast for the Lottery
  - We anticipate an upward adjustment of approximately $100.0 million

# Revenue Outlook for 2008 - 2010

- The underlining revenue outlook for payroll withholding is for revenue growth to be consistent with historical trends of between 5.5% and 6.0%
  - Consistent with last year's outlook
- Sales tax is expected to grow below the rate of personal income
  - Adjustments in the sales tax base reflecting a decline in housing related sales tax activity
  - Will we have another strong holiday for retailers?
    - Nationally, sales are expected to increase about 4 – 5 percent over last year's holiday season
    - Higher energy prices could play a role

# Corporate Taxes - Profit Boom is Nearing Its End

- Corporate taxes: Collections posted four consecutive double digit year-over-year growth through FY 2006
- Strength continued at 5 percent in FY 2007, reflecting strong earnings and profits among defense, technology and oil companies
- FY 2008 corporate income is forecasted to decline due to housing related companies (home builders, financials, building supply companies)
- For the CY 2007, corporate profits are up around 6 percent, however, according to Thomson Financial, growth in 3rd quarter profits among the S&P 500 was running at 3%, the smallest gain in five years
    - Financial firms, which accounts for 25 percent of the companies, are largely to blame
- FY 2009 should see flat corporate tax revenues as the housing sector begins to stabilize

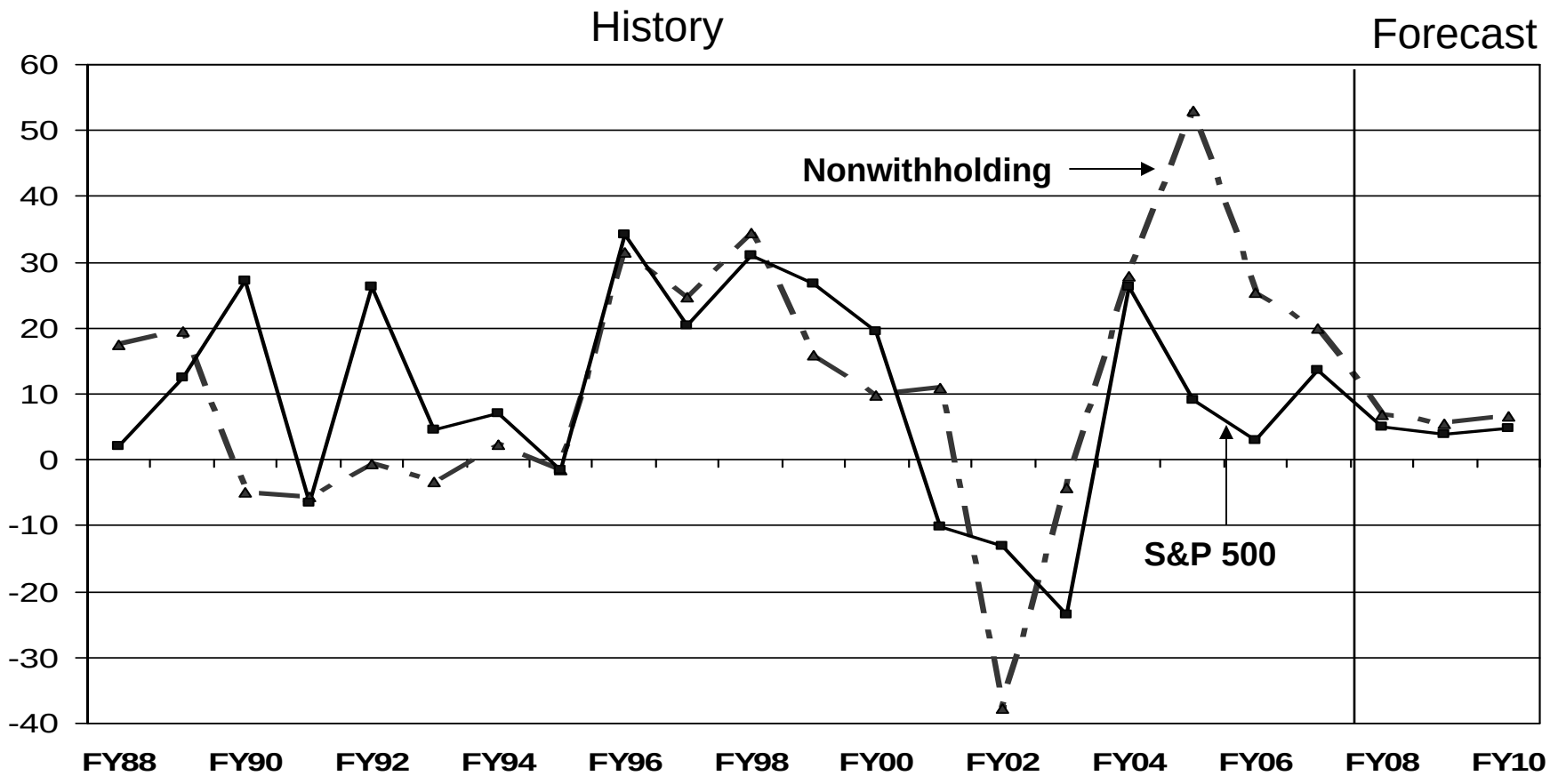


# Nonwithholding Taxes

- Nonwithholding taxes: FY 2007 grew nearly 6.6% over the previous year.
  - Greater than the forecast assumed due to strength in the stock market
- FY 2008 Nonwithholding payments: June and September estimated payments for tax year 2007 are up 10.8 percent over the same period in TY 2006
  - S&P 500 is up about 3% YTD

# Final Nonwithholding Taxes vs. S&P 500 Index

*Percentage Change Over Previous Fiscal Year*

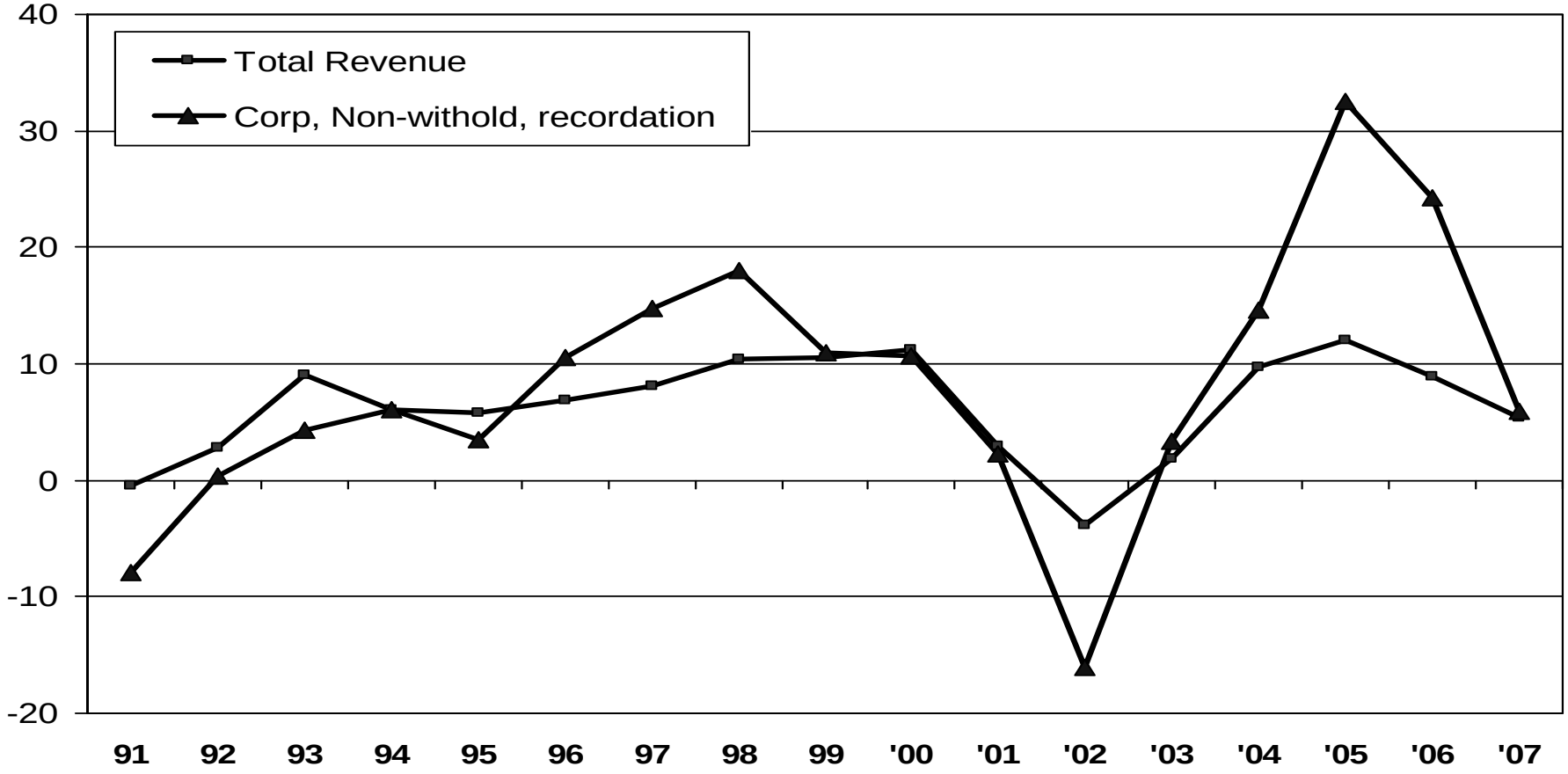


# Volatility in Tax Sources

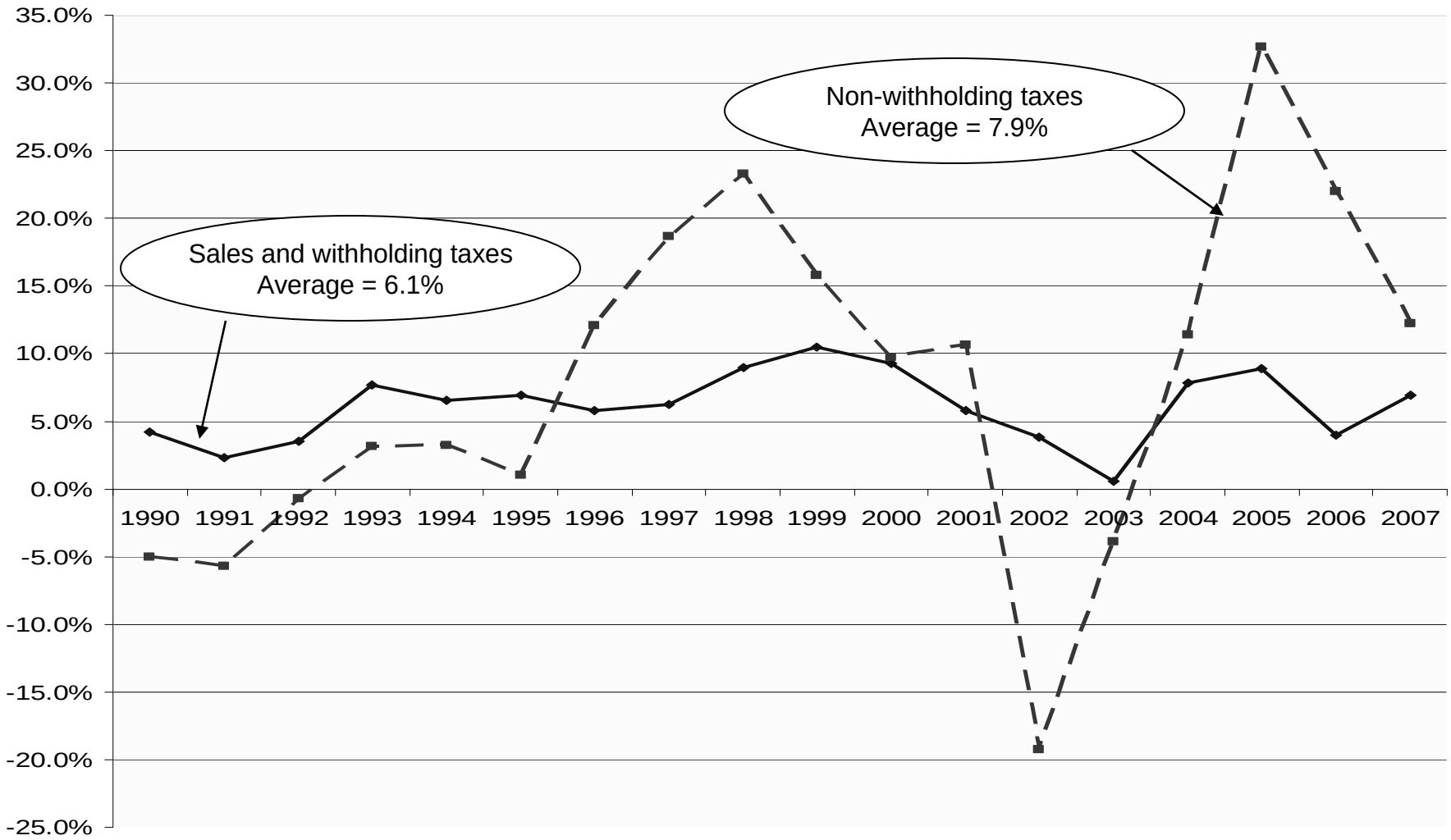
- Total General Fund Revenues Have Become Increasingly Volatile
- The increased significance of individual nonwithholding, corporate income, and recordation tax have introduced additional variability into collections.
  - Taken together, the three most volatile revenue sources represented 28 percent of total revenues in FY07
  - Historically these sources have made up 21 percent of GF revenues
- Trend in volatility likely to be exacerbated based on several factors
  - Seeing greater impact from reduction in housing-relating sales which made up almost 20 percent of sales
  - Several tax policy changes have impacted refunds, i.e. land conservation tax credit, low income tax credit
  - Stock market performance, which is tied to corporate earnings

# Volatility in Tax Sources

**Volatility in Total Revenues, FY91-07**
Percent Growth Over the Prior Year

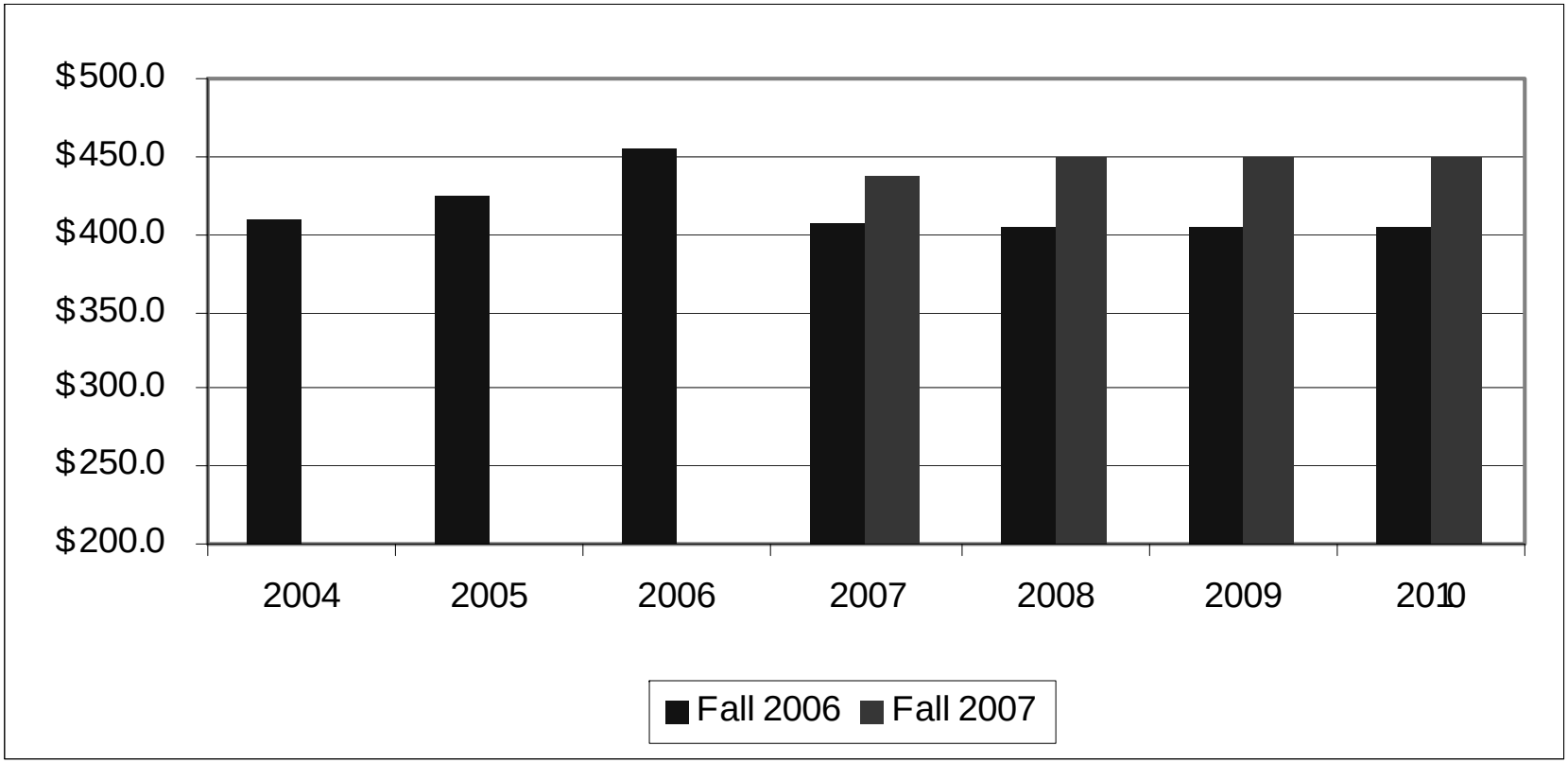


# Comparison of Sales and Withholding Taxes to Non-Withholding Taxes



# Virginia Lottery Revenues

(in millions)




- The decrease in revenues due to the start-up of the North Carolina Lottery has not been as much as expected
- Revenues still projected to be below FY 2006 record amount of $454.9 million (prior to North Carolina lottery)

# What Does this Mean for Revenue Growth?

- The overall GF growth rates for 2008–2010 suggest a revenue outlook that is not materially changed from the August re-forecast
  - FY 2009: 3.2 percent
  - FY 2010: 6.7 percent

- Revisions to the Lottery forecast based on the FY 2007 performance and the introduction of new games to counter the North Carolina lottery
  - Revision produces $44.6 million in additional revenues in FY 2008
  - The forecast increase is carried forward into FY 2009 and FY 2010 as well
  - Revenues are split 60% for basic aid and 40% to local schools for technology

- Revenue numbers also reflect several tax policy adjustments resulting from previous legislative actions, including the elimination of the estate tax and the impacts of HB 3202

# Policy Adjustments Reflect Actions Approved in 2006 and 2007

| | FY 09 | FY 10 |
|---|---|---|
| Land Preservation Tax Credit | $125.0 | $70.0 |
| Filing Threshold | $13.6 | $13.4 |
| Sales Tax Holiday:Hurricane/ Energy Efficient | $1.7 | $1.8 |
| Annualize Estate Tax Repeal | $78.0 | $78.0 |
| 1/3 Ins. Premium to TTF* | $134.5 | $139.6 |
| 3 cents Recordation to TTF | $53.9 | $58.8 |

*A corresponding adjustment in the GF operating budget of $110.0 million is made reflecting the appropriation in FY 2008

# Final Thoughts on the Economic Outlook for 2008-2010

- Risk to the Forecast
  - Energy costs
  - Continued slump in housing market
  - Consumer confidence
  - Stock market volatility
  - Federal procurement spending
  - International impacts – weakness in dollar
- Forecast represents a revenue outlook developed in the fall of 2007 for a period that begins in July 2008 and runs for 24 months
  - Updated in February 2008 (Mid-Session forecast)

# 2008 Session
# What Are the Issues?

# 2008 Session
## Fiscal Year 2008 Challenge

- Meet revenue shortfall
- Address spending adjustments for FY 2008
  - Technical and forecast adjustments in Health and Human Resources (CSA) and K-12
  - Jail per diems, involuntary civil commitment, and the criminal fund
- Generate cash to carryforward into FY 2009 for commitments

# FY 2008 Revenue & Technical Budget Adjustments

| | Amount ($ in millions) |
|---|---|
| August Revenue Shortfall | (641.0) |
| ***Post-August Revenue Adjustments*** | |
| November Reforecast | 50.4 |
| 2008 Reforecast Additional Lottery Revenue | 47.7 |
| 2007 Actual Lottery Revenues Exceed Forecast | 31.0 |
| ***Technical Budget Adjustments*** | |
| Medicaid Forecast Savings | 49.7 |
| Technical Adjustments for ADM (K-12) | 22.5 – 26.6 |
| Revised Rainy Day Fund Deposit | 8.5 |
| | |
| Total FY 2008 Revenue Gap | (427.1 – 431.2) |

# FY 2008 Spending Pressures

| | Amount ($ in millions) |
|---|---|
| Comprehensive Services Act | 54.3 |
| Backfill Sales Tax in SOQ Formula | 22.6 |
| Criminal Fund | 16.4 |
| Jail Per Diems | 14.8 |
| DSS Offset Revenue Loss from new federal cost allocation plan | 10.0 |
| Comp Board Fringe Rate Adjustments | 7.5 |
| Inmate Health Costs | 5.6 |
| Involuntary Civil Commitment | TBD |
| Children's Health Insurance (FAMIS / SCHIP) | 2.2 |
| | |
| Total FY 2008 Spending Pressures | 133.4 |

# FY 2008 Strategies to Address Budget Shortfall

| | Amount ($ in millions) |
|---|---|
| Governor's October Budget Adjustment Strategies | 300.3 |
| Revert Previously Identified GF Balances | 100.0 |
| Revert Other GF Balances | 25.0 – 30.0 |
| Cost Overruns on Prior Bond-funded Projects (Bonds for GF) | 150.0 – 200.0 |
| Freeze Capital Projects in Chapter 847 Prior to Contract Issuance | 100.0 – 150.0 |
| | |
| Total FY 2008 Budget Strategies to Address Shortfall | 675.3 – 780.3 |

# FY 2008 Budget Summary

| | Amount ($ in millions) |
|---|---|
| FY 2008 Revenue Gap | (427.1 – 431.2) |
| Total FY 2008 Spending Pressures | (133.4) |
| **FY 2008 Estimated Total Budget Gap** | **(560.5 – 564.6)** |
| | |
| **Total FY 2008 Budget Strategies to Address Shortfall** | **675.3 – 780.3** |
| | |
| **Available for Carryforward for FY 2009** | **110.7 – 219.8** |

# Budget Outlook for FY 2008-10 Biennium

- How much does it cost to keep doing what we are doing?
  - Base budget equals fiscal year 2008
    - With one-time spending back-out
    - Annualization of partial-year adjustments – spending requirements and budgetary savings identified
    - Carry-forward of $300.3 million in FY 2008 savings identified by Governor in October
- What are required adjustments for known budget drivers?
  - Mandatory and statutory only
  - How does it all fit?

# Adjusted Base Budget for FY 2009/10

*(GF Dollars in Millions)*

| | FY 2009 | FY 2010 |
|---|---|---|
| Chapter 847 (FY 2008 Base) | $17,641.3 | $17,641.3 |
| Remove Capital Outlay | ($308.1) | ($308.1) |
| Annualize Partially Funded Costs (FY 2008 Salary Increases, rent and insurance costs, etc.) | $83.4 | $83.4 |
| Remove One-Time Spending (includes $184 m. Rainy Day Fund Payment) | ($305.2) | ($305.2) |
| Remove Identified Budget Reductions | ($300.3) | ($300.3) |
| * Expected FY 2009 Rainy Day Fund Payment | $21.3 | |
| HAC Estimated Base Budget | $16,843.2 | $16,864.5 |
| | | |
| **Resources Based on Reforecast** | **$17,430.2** | **$18,542.1** |
| | | |
| Revenues Above Base | $587.0 | $1,677.6 |
| FY 2008 Carry Forward | $100 - 225 | |

# FY 2008-2010 Biennium

- Known 2008 - 2010 budget obligations include:
  - Biennial update of SOQ funding
  - Medicaid and FAMIS forecast
  - Debt service for tax-supported bonds
  - CSA and foster care cost increases
  - Opening new prisons
  - Employee health insurance/VRS rates

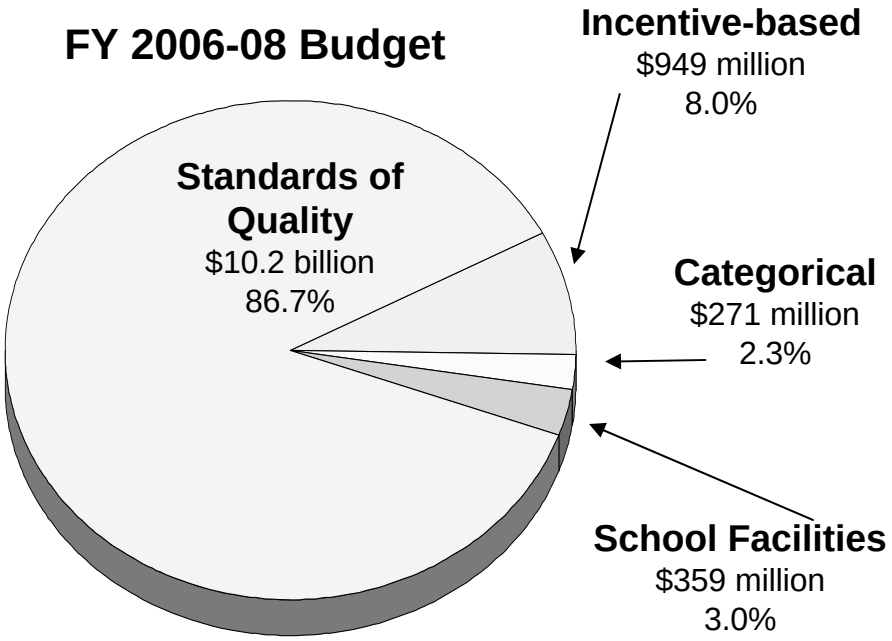
# Public Education Budget Issues – Rebenchmarking

# SOQ Rebenchmarking: General Process

- Rebenchmarking the SOQ occurs in even-numbered years
- Rebenchmarking is the process of updating the state cost of the Direct Aid budget for each biennium
  - FY 2008 is the starting point used to determine the changes in costs that occurred over the previous biennium
  - This will determine the amount of state funding required for the Standards of Quality (SOQ) and other Direct Aid accounts for the new biennium
- Based on three funding guidelines referenced in the *Constitution of Virginia*:
  - "Must be realistic in relation to current educational practice"
  - "Must be realistic in relation to current costs for education"
  - The local share of SOQ costs "must be based on local ability to pay"

# Preliminary Rebenchmarking Costs

- In July, Department of Education (DOE) reported preliminary rebenchmarking cost estimates for the 2008-2010 SOQ accounts and incentive and categorical programs at $1.1 billion above the current biennium
  - Does not reflect any changes to policies or funding formulas
  - Does not reflect final ADM, sales tax or lottery




Total Funding $11.8 billion

General Fund $11.5 billion
Other revenues 0.3 billion

# Preliminary Costs – Rebenchmarking Factors

- Technical updates to data elements for the Direct Aid accounts and biennial cost estimates include

| Student Data | ($ in millions) |
|---|---|
| □ Student average daily membership (ADM): | $77.3 |
| ▪ FY 2009: 10,672 additional students to 1.21 million | |
| ▪ FY 2010: 11,309 additional students to 1.22 million | |
| □ English as a Second Language enrollment forecast: | 14.8 |
| □ Remedial Summer School enrollment forecast: | 9.5 |
| □ SOL test scores & free lunch eligibility: | 6.4 |
| ▪ SOQ intervention, prevention & remediation | |
| ▪ At-Risk Add-on | |
| ▪ Virginia Pre-school Initiative (VPI) | |
| □ Special Education: | (14.2) |

# Preliminary Costs – Rebenchmarking Factors

| Salary and Benefit Data | ($ in millions) |
|---|---|
| □ Teacher salary base adjustments | $211.8 |
| ■ Elementary = $44,337 (up from $39,681) | |
| □ 11.7% increase over prior biennium | |
| ■ Secondary = $46,230 (up from $41,615) | |
| □ 11.1% increase over prior biennium | |
| □Prevailing health care premium costs | $124.5 |
| ■ $5,211 (up from $4,274) | |
| □ 21.9 % increase over prior biennium | |

# Preliminary Costs – Rebenchmarking Factors

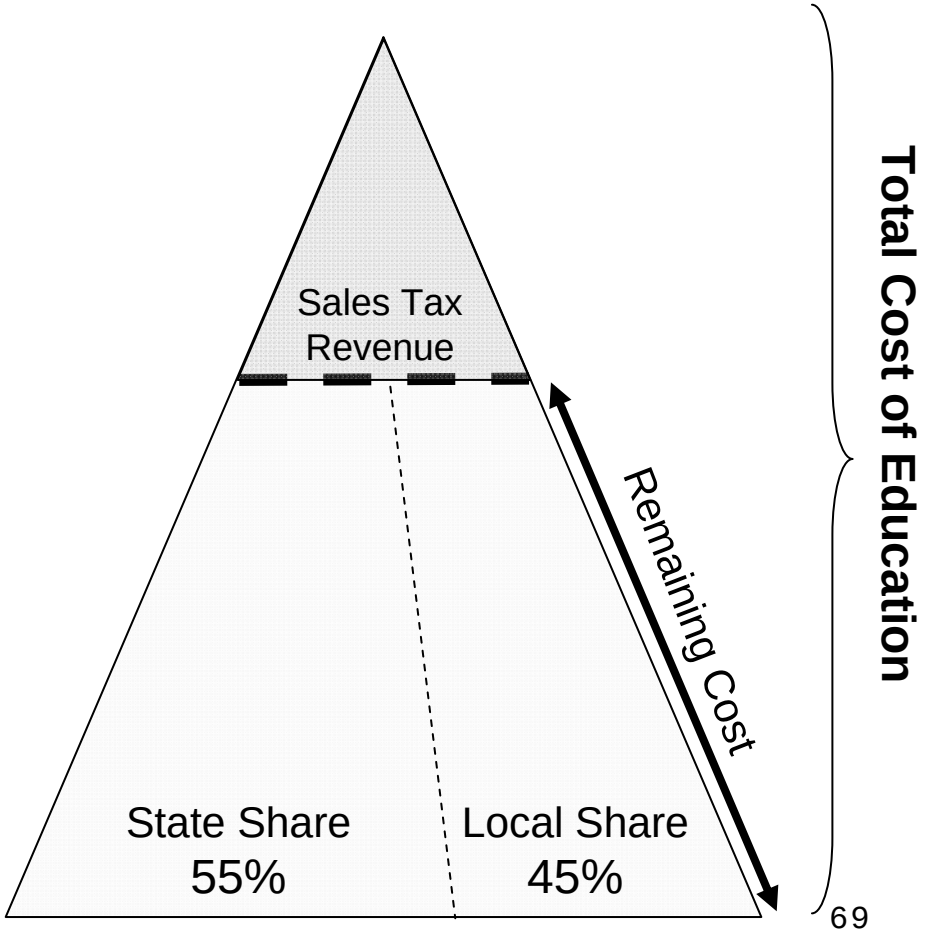
| Other Data | ($ in millions) |
|---|---|
| ☐ Non-personnel support costs in basic aid | $418.7 |
| ☐ Net Inflation factor | 84.8 |
| ▪ 5.39% (Would be 7.30% without a soft cap) | |
| ▪ Recognize 100% inflation up to 5.0%, & .35 thereafter | |
| ☐ Pupil transportation costs | 78.8 |
| ☐ Incentive program updates | 45.9 |
| ☐ Prevailing textbook costs | 25.1 |
| ▪ $119.39 PPA - 17.3% increase | |
| ☐ Fully fund programs reduced for non-participation | 25.1 |
| ▪ Virginia Pre-school Initiative | |
| ☐ Categorical program updates | 17.8 |
| ☐ Composite index | 9.9 |
| ▪ 44 increased, 84 decreased, 8 unchanged | |
| ☐ Federal revenue deduct | (26.0) |

# Preliminary Costs – Rebenchmarking Factors

- Teacher retirement and retiree health care credit rates have not been updated yet
- Final enrollment projections (September 30, 2007 data)
  - Actual September 30, 2007 membership is 6,649 lower than projected in Chapter 847
    - Based on the lower Sept 2007 ADM, the 2008-2010 ADM cost will be lower than assumed in the July estimate
  - Head Start enrollment (for VPI funding formula)
    - Children served by Head Start program will decrease the remaining number of four-year-olds eligible for the VPI program
- All data updates and calculations will be completed and reflected in the Governor's introduced budget in December

# Updates to Sales Tax and Lottery Forecast Will Impact Final Estimate of State Share of Costs

- Sales tax
  - Used as the first dollars to pay for total K-12 cost
    - An increase in sales tax revenue will lower the remaining cost that is split between the state and localities
- Lottery
  - About 60% of lottery revenues are used to fund a portion of the state's share of SOQ basic aid costs
  - October's forecast provides an additional $27 million each year for basic aid payments



# Final Rebenchmarking Costs Will Reflect Policy Review

- The rebenchmarking process is not limited to data updates
  - Embedded policies are reviewed to ensure their continued relevance and necessity
- Preliminary cost estimates may be adjusted to reflect policy decisions
- In prior biennia, rebenchmarking costs were mitigated by policy changes adopted by the General Assembly and the Governor – such as:
  - Federal and local revenue deduct per pupil amounts
    - Use of cap limits (locality vs. state average)
    - Eliminates a double-dip for funding
  - Evaluation of inflation factors

# Health & Human Resources Budget Issues

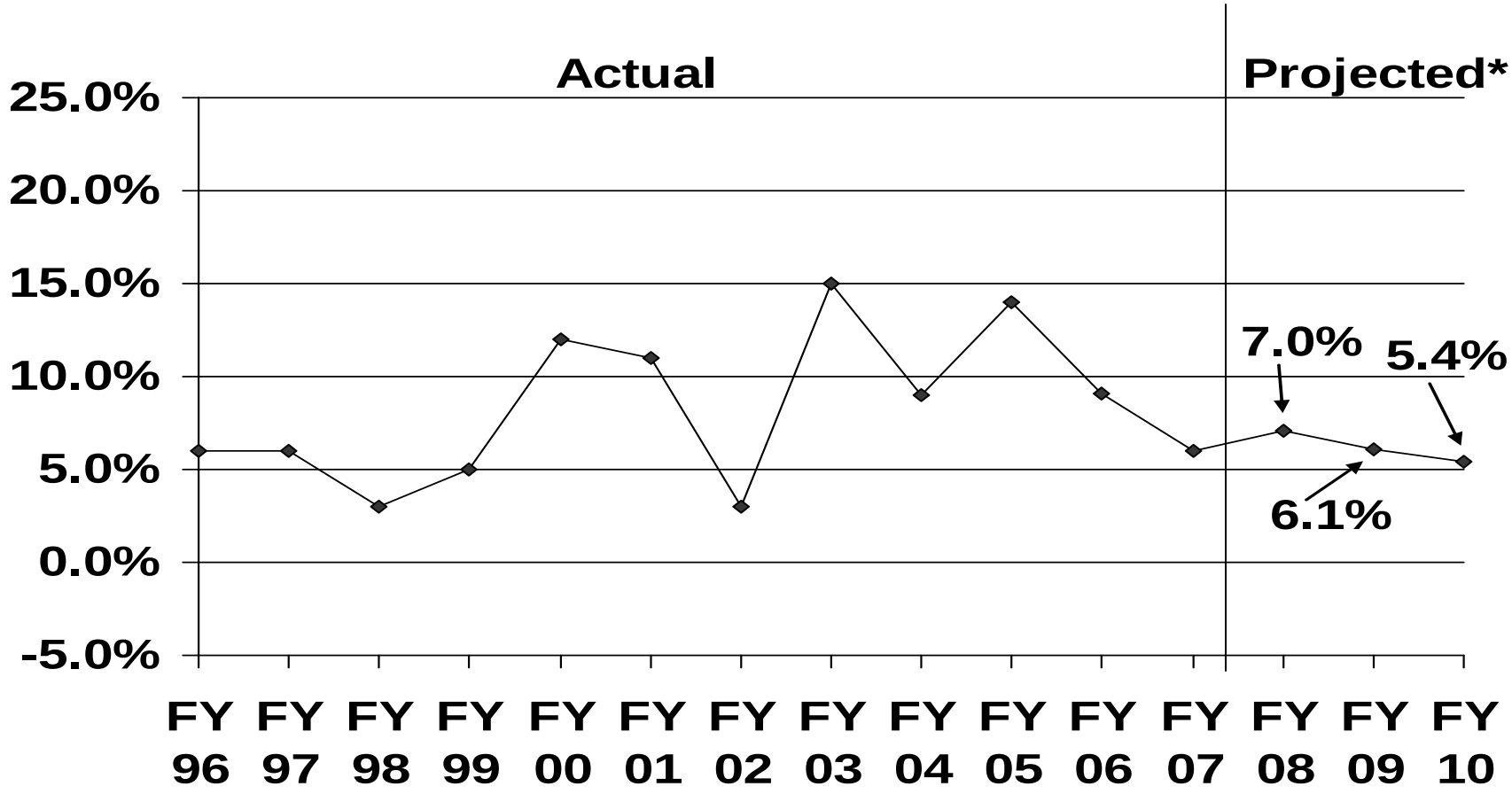
# Agency Requests

- Mandatory Programs
  - Medicaid and Children's Health Insurance
  - Comprehensive Services Act
  - Foster Care
  - Adoptions

# Medicaid Utilization & Inflation

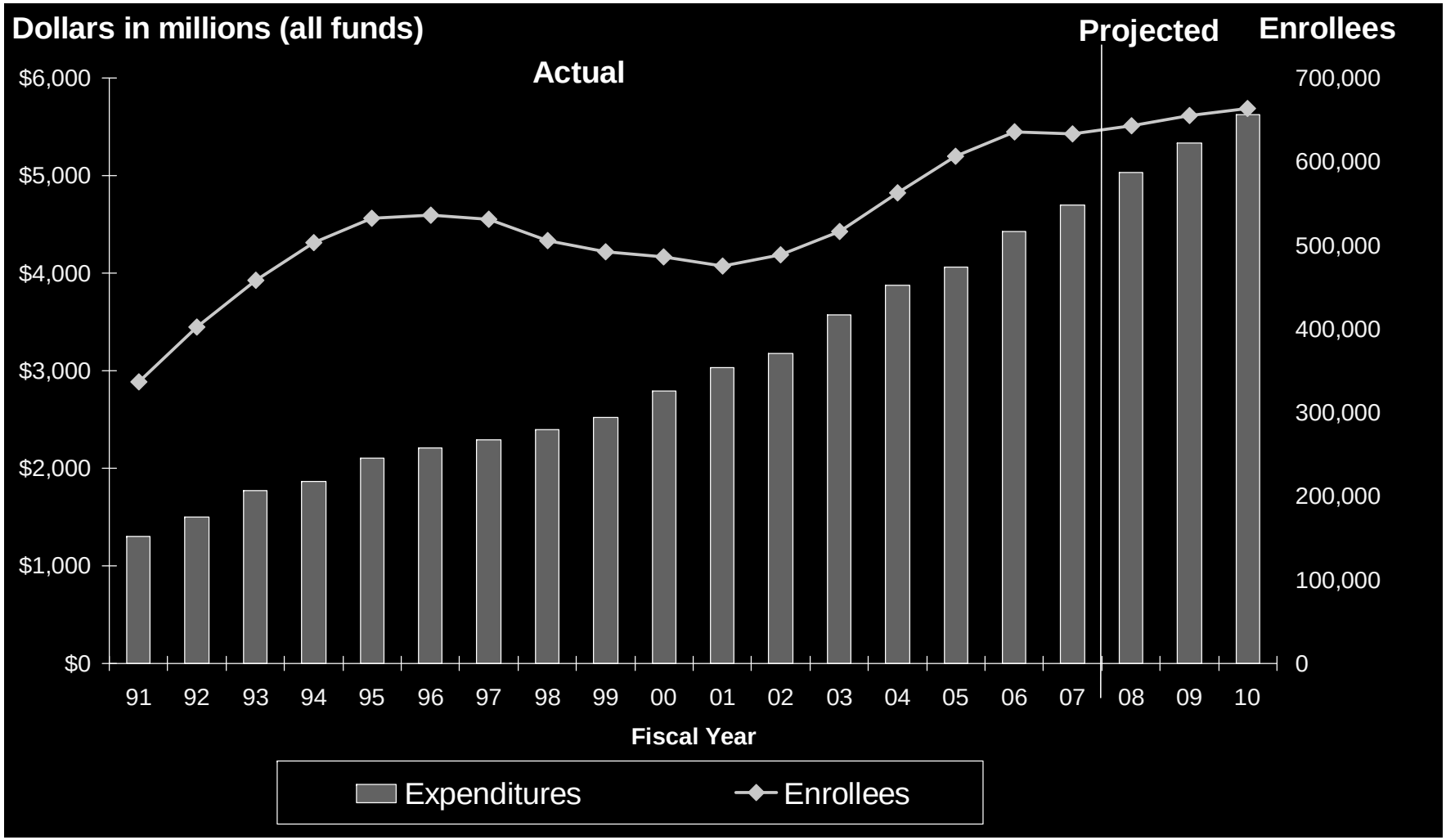
(all funds)

- Average annual expenditure growth: 8.3% historical, 6.2% projected




Source: DPB and DMAS Consensus Forecast

# Growth in Medicaid Medical Expenditures Compared to Growth in Enrollees



## Factors Resulting in Lower Medicaid Growth

- FY 2007 expenditures were significantly below projections
  - Results in a lower base expenditure level going into FY 2008
- Lower Enrollment Growth
  - Children, pregnant women and low-income adults actually decreased in FY 2007
    - Thought to be related to federal citizenship and identity requirements
  - Aged and disabled individuals increased 4% in FY 2007, lower than the 6% growth rate in FY 2006
- Overall health care inflation seems to be moderating
  - Part B Medicare premiums will increase 3.1% in January 2008, increases the last 2 years were 13% and 5.6%
- Rebasing of nursing home rates
  - Cost of nursing facility rebasing in FY 2009 is significantly lower than prior year rebasing of costs

# Medicaid Expenditures & Funding Need for 2008-10 Biennium

(GF $ in millions)

| Fiscal Year | State GF Medicaid Expenditures | % Inc. | % Growth FY 08 to FY 10 | Base Appropriation State Funds | Addt'l. Funding Need | % Change |
|---|---|---|---|---|---|---|
| FY 2008 | $2,599.4 | 7.4% | | $2,649.1 | ($49.7) | (1.9%) |
| FY 2009 | $2,748.3 | 5.7% | | $2,649.1 | $99.2 | 3.7% |
| FY 2010 | $2,894.9 | 5.3% | 11.4% | $2,649.1 | $245.8 | 9.3% |

Note: The base appropriation for FY 2008 is adjusted to reflect carry forward savings amounts included in the October 2007 Governor's budget reduction plans.

# Department of Medical Assistance Services Budget Requests

(GF $ in millions)

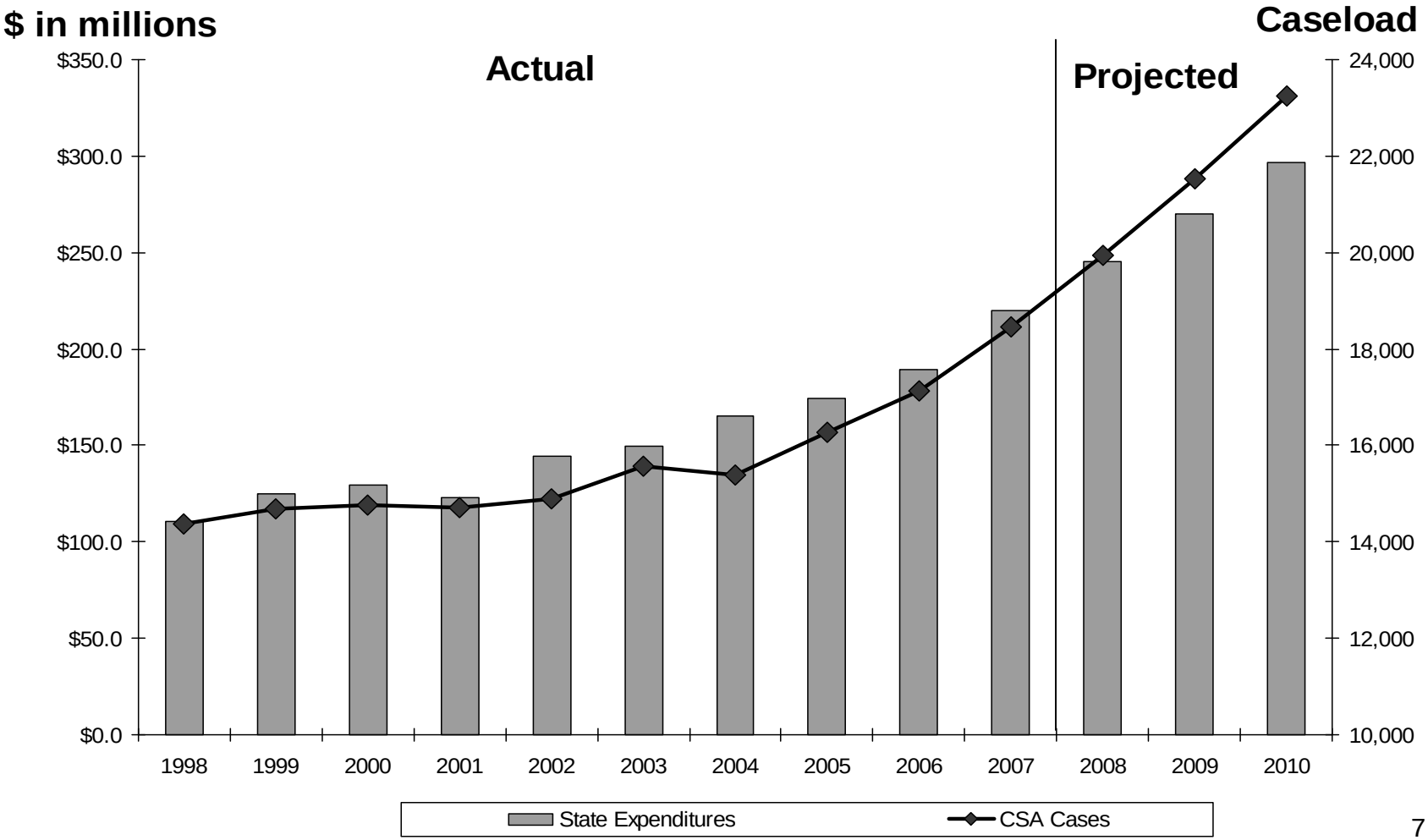
| DMAS Programs | FY 2008 | FY 2009 | FY 2010 |
|---|---|---|---|
| Medicaid Utilization & Inflation | ($49.7) | $99.2 | $245.8 |
| Children's Health Ins. (FAMIS & SCHIP) | $2.2 | $10.3 | $16.9 |
| Involuntary Mental Commitments | TBD | TBD | TBD |
| Note: The GF need for Medicaid Utilization & Inflation will be adjusted when the projected revenues for the Virginia Health Care Fund (VHCF) are finalized. | | | |

# Comprehensive Services Act (CSA)

- CSA coordinates local services for emotionally and behaviorally disturbed children
- Localities are mandated to serve eligible children, most of whom are special education and foster care cases
- Both caseloads and the cost of services continue to grow

# Growth in CSA

- Average annual expenditure growth: 8.1% historical, 10.6% projected – continues recent trends



# Factors Driving CSA Costs

- Increases in the number of children served – 8% annual growth projected
- Number of children receiving more intensive services is growing
  - In FY 2007, 78 more children receiving services costing more than $100,000
  - 82 more children with special education disability of autism
- 3 service types are driving expenditure increases:
  - Therapeutic foster care (29% of total expenditure increase)
  - Special education private day placement (23% of total expenditure increase)
  - Residential treatment facility (17% of total expenditure increase)
- New state law requires CSA to serve children requiring mental health services to avoid placement in foster care
  - JLARC Spring 2007 estimate of fiscal impact is $14.3 million annually
  - CSA estimates of the cost of the new law will be available in December

# CSA Budget Request

(GF $ in millions)

| CSA Budget Request | FY 2008 | FY 2009 | FY 2010 |
|---|---|---|---|
| Caseload & Expenditure Growth | $40.0 million | $49.7 million | $75.9 million |

# Foster Care and Adoption Assistance

- Foster care provides payments for room, board, clothing, and daily supervision (maintenance)
- Of 8,122 children in foster care, 54% are eligible for Title IV-E of the Social Security Act
- State share of expenses for Title IV-E eligible is 50%
- Foster care maintenance expenses for non-Title IV-E eligible children are paid through the Comprehensive Services Act program
- Adoption Assistance is provided to help place foster care children who are considered hard to place and who would likely remain in long-term foster care without such assistance

# Foster Care Expenses for Title IV-E Children

- Caseload growth is leveling
- Title IV-E expenditures increased on average by 17.8% annually over the 10-year period between FY 1998 and FY 2007
- Expenditure growth rate in the 2008-10 biennium is projected to be lower than previously
  - 10.1% growth in FY 2009
  - 4.4% growth in FY 2010
- Budget request for foster care funding for the 2008-10 biennium includes a rate increase of 15% in the first year and 10% in the second year for maintenance payments
  - Cost is $1.7 million GF
  - Intent is to maintain and increase the number of foster family homes
  - Foster care rates paid directly to families are lower than those paid to families recruited, licensed and trained by child placing agencies

# Factors Driving Foster Care and Adoption Assistance Expenditure Growth

- Foster care expenditure growth due to:
  - Caseload growth
  - Increased use of higher cost settings
    - Group homes, therapeutic foster care and residential services
      - These cost are unregulated
      - Many localities have trouble negotiating rates and comparing services across providers
  - Rate increase for maintenance payments to foster family homes
- Adoption assistance growth due to
  - Moderate growth of about 5% annually in the number of children to be served (down from an average of 12% annual growth)
  - Rate increase for maintenance payments

# Department of Social Services (DSS) Budget Requests

(GF $ in millions)

| DSS Budget Request | FY 2009 | FY 2010 |
|---|---|---|
| Foster Care | $3.4 million | $5.0 million |
| Adoption Assistance | $3.3 million | $7.2 million |

# Summary of Budget Drivers

# 2008-10 Budget Drivers

## Selected Mandatory/Statutory Spending

| GF $ in Millions | FY 2009 | FY 2010 | Total |
|---|---|---|---|
| K-12 Prelim Re-benchmarking (SOQ, Incentive & Categorical) | 520.3 | 581.5 | 1,101.8 |
| K-12 Net Lottery (Local Share) | 18.0 | 18.0 | 36.0 |
| Medicaid Utilization and Inflation (Preliminary) | 99.2 | 245.8 | 344.9 |
| Capital Outlay – Treasury Board Debt Service | 55.0 | 105.0 | 160.0 |
| Comprehensive Services Act | 49.7 | 75.9 | 125.6 |
| Children's Health Insurance (FAMIS / SCHIP) | 10.3 | 16.9 | 27.2 |
| Foster Care and Adoption Assistance | 6.7 | 12.2 | 18.9 |
| Sheriffs – Per Diem Payments, New Deputies - 1:1500 & Jail | 31.9 | 47.6 | 79.5 |
| Criminal Fund | 21.5 | 29.3 | 50.8 |
| VRS Rates State Employees (cost depends on actuarial assumptions used to determine rates) | (5.8) / 32.3 | (5.8) / 32.3 | (11.6) / 64.6 |
| VRS Rates (Teachers) (cost depends on actuarial assumptions used to determine rates) | (42.0) / 43.6 | (42.0) / 43.6 | (84.0) / 87.8 |
| State Employee Health Insurance Rate Adjustments | 29.7 | 31.0 | 60.7 |
| JMU Hospital Acquisition – Final Payment | 8.0 | 0.0 | 8.0 |
| 599 Program | 6.6 | 13.7 | 20.3 |
| Direct Inmate Health Care | 11.9 | 19.4 | 31.3 |
| Involuntary Mental Commitment Fund | TBD | TBD | TBD |

# Final Thoughts

# FY 2009 Is the Challenge

- The revenue forecast projects sufficient revenue growth to fund major budget drivers in FY 2010
- However, slower revenue growth in the first year coupled with economic uncertainty results in some FY 2009 challenges
- Because costs of items like the SOQ rebenchmarking are almost as high in the first year, the challenge will be funding FY 2009 costs
- Based on actions to meet the 2008 shortfall and the projected spending and revenue increases for FY 2009, the potential budget gap could be between $50 and $150 million
  - No budget gap is foreseen in FY 2010 based on current outlook

# What Are the Strategies?

- No new programs or program expansions
- Level fund or freeze programs
- Review programs for alternative funding - i.e., federal funds, fees
- Review proposed inflation factors
- Funding methodologies – e.g. VRS rates
- Targeted and across-the-board reductions