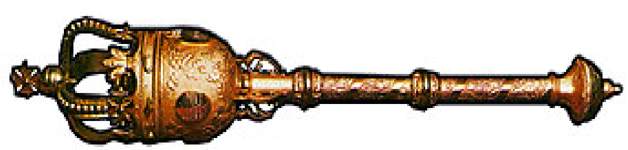
How Will the Fiscal Year 2014 Revenue Shortfall Impact the 2014-16 Revenues and What are the Strategies to Close the Budget Gap

House Appropriations Committee

June 11, 2014



2014 Adjustments to the Revenue Forecast

- The December forecast for FY 2014 assumed a very tepid 1.7% growth rate
  - FY 2014 forecast was reduced by $125.0 million during the Mid-Session review and the overall growth rate for the year was lowered to 1%
  - Downward adjustments were made to estimated payments, withholding and corporate income tax
- With the exception of a $15.0 million adjustment to withholding in FY 2015, Governor McAuliffe chose not to adjust the revenue base for the new biennium or the growth rates for FY 2015 or FY 2016

2014 Mid-Session Reforecast	FY 2014	FY 2015	FY 2016
Withholding	$35,000,000	$15,000,000	$0
Nonwithholding	$60,000,000	$0	$0
Corporate Income	$30,000,000	$0	$0
Total Adjustment	$125,000,000	$15,000,000	$0
Growth Rate	1.0%	4.2%	3.9%

FY 2014: Where Do We Stand Year-To-Date?

- When the Mid-Session reforecast was presented, the Governor indicated a continued belief that the forecast would be made, however, it was acknowledged that achieving the forecast was heavily dependent on final payments from estimated payers
- After a strong April, the May daily deposits were far weaker and it was becoming apparent that final payments would not meet the forecast
- At this point, revenues for FY 2014 are about $350.0 million below forecast
- While estimated payments is the primary source for the shortfall, payroll withholding for FY 2014 continues to grow at an anemic rate of 3%, consistent with the forecast
  - This will mark the second year of payroll growth at 3%, however the forecast for FY 2015 and FY 2016 assumes over 4% growth
  - Payroll withholding accounts for approximately 60% of general fund revenue collections

General Fund Revenue Forecast for Fiscal Year 2014

($ in Millions)

Major Source	December Forecast		MidSession Reforecast		Assumed Actuals	
Withholding	**10,585.2**	**3.3%**	**10,550.2**	**2.9%**	**10,550.2**	**2.9%**
Nonwithholding*	**2,984.3**	**6.3%**	**2,924.3**	**4.2%**	**2,574.3**	**-8.3%**
Refunds	(1,807.1)	5.1%	(1,807.1)	5.1%	(1,807.1)	5.1%
Net Individual	**11,762.4**	**3.7%**	**11,667.4**	**2.9%**	**11,317.4**	**-0.2%**
Sales	3,079.4	-4.4%	3,079.4	-4.4%	3,079.4	-4.4%
Corporate	**799.9**	**0.4%**	**769.9**	**-3.4%**	**769.9**	**-3.4%**
Wills (Recordation)	377.5	0.0%	377.5	0.0%	377.5	0.0%
Insurance	289.4	10.4%	289.4	10.4%	289.4	10.4%
All Other Revenue	662.3	-3.8%	662.3	-3.8%	662.3	-3.8%
Total GF Revenues	**16,970.9**	**1.7%**	**16,845.9**	**1.0%**	**16,495.9**	**-1.1%**
Assumed Shortfall					**(350.0)**	

Note: FY 2014 “Assumed Actuals” are illustrative only, based on Secretary of Finance’s estimate that nonwithholding payments are likely to fall short in the range of $350.0 million. No other sources are adjusted.

Prudence Suggests that the General Assembly Should Prepare the 2014-16 Budget Based On Lower Revenues

- The budget will be built with a large revenue reserve based on the assumption that the FY 2014 forecast will not be met and a general fund revenue reforecast for the upcoming biennium will be required
  - Because of the FY 2014 shortfall’s impact on carry-forward revenues, the magnitude of the FY 2015 problem is expected to be around $850.0 to $950.0 million
  - FY 2016 shortfall could be in excess of $500.0 million
- Objective would be to enact a budget in order to access the Revenue Stabilization Fund during the 2015 Session
- Set aside at least $800.0 million in a Revenue Reserve

How Will a FY 2014 Shortfall Impact the 2014-16 Budget?

- Chapter 1 (Caboose Bill) contains sufficient balances to absorb shortfall, however, the carry-forward balance will be less than assumed in HB 5002, creating a hole in the FY 2014-16 budget
- Within 5 days of the close of FY 2014, the State Comptroller must certify whether the forecast was met
  - If total revenue collections are 1% or more below the forecast, the Governor is required to prepare a re-estimate of general fund revenues for the new biennium
  - The re-estimate must be provided to the General Assembly no later than September 1st

How Was Similar Situation Handled in 2009?

- When Secretary Brown presented the May revenue report to the House Appropriations Committee on June 16, 2009, he announced that Governor Kaine had ordered a revenue reforecast ahead of the certification required under Title 2.2
  - Reforecast was to be completed and presented to the Joint Money Committees at the August meeting
  - At this time DPB already was working on budget reduction strategies
- GABE met to review the interim economic outlook on July 14, 2009
- GACRE met to review the proposed forecast on August 5, 2009
- It should be noted that unlike the present situation, the General Assembly already had adopted a budget. Once the reforecast was complete the Governor could undertake executive actions to align the budget with the new forecast

Once the Comptroller Certifies FY 2014 Revenues, What Is the Official Revenue Estimate?

- So what is the forecast?
  - The forecast is not simply a dollar number, rather it is the end result of a process set out in §2.2-1503, *Code of Virginia*, which examines economic activity with respect to economic assumptions and econometric methodology of future revenues to support the biennial budget
  - Simply put, these inputs are the rates of growth and are applied to the base revenue year – i.e. the year preceding the forecast period (the biennial budget period)
- If a budget has not been adopted by the time the certification is complete, the General Assembly has two options:
  - Wait for the completion of the reforecast
  - Apply the official revenue growth rates for FY 2015 and FY 2016 against the certified FY 2014 revenue base

What Are the Growth Rates that Support the Introduced FY 2014-16 Biennial Budget?

- When announced in December, the overall GF growth rates for the FY 2014–2016 biennium assumed 4.2% in FY 2015 and 3.9% in FY 2016 (inclusive of tax policy changes)
- These growth rates are applied against an assumed FY 2014 revenue base
  - HB 29 had assumed growth of 1.7% in FY 2014 over FY 2013 actuals
- Once the certification of FY 2014 is complete, that becomes the revenue base against which the forecasted growth rates are applied
- To illustrate the potential impact on the upcoming biennium, if we applied the official (December) growth rates to the certified FY 2014 revenues, significant adjustments to the expenditures proposed in HB 5002 would be required

General Fund Revenue Forecast for FY 2014-16 Biennium

($ in Millions)

Source	FY 2015 % Growth Dec Forecast	FY 2015 Forecast Based on December 2013 Forecast	FY 2015 Forecast Based on Assumed FY 14 Actuals	FY 2016 % Growth Dec Forecast	FY 2016 Forecast Based on December 2013 Forecast	FY 2016 Forecast Based on Assumed FY 14 Actuals
Withholding	4.3%	11,040.4	**10,988.9**	4.2%	11,504.1	**11,450.4**
Nonwithholding	7.4	3,203.7	**2,764.8**	5.9	3,393.6	**2,927.9**
Refunds	4.3	(1,885.0)	(1,885.0)	4.2	(1,965.0)	(1,965.0)
Sales	3.1	3,175.7	3,175.7	2.6	3,256.7	3,256.7
Corporate	2.1	816.6	**786.1**	0.7	822.7	**791.6**
Recordation	0	377.5	377.5	0	377.5	377.5
Insurance	0.5	290.9	290.9	4.2	303.1	303.1
All Other	0.6	666.3	666.3	2.1	680.6	680.6
Total GF Revenue	**4.2%**	**17,686.1**	**17,165.2**	**3.9%**	**18,373.3**	**17,822.9**
Shortfall Compared to Current Forecast			**520.9**			**550.4**

Note: These adjustments are exclusive of the assumed $350.0 million shortfall in the carry-forward amount from FY 2014 and assumes no forecast adjustments to the FY 2015 and FY 2016 growth rates.

How Are We Building a Budget Given the Uncertainty?

- As indicated earlier, prudence suggests that the General Assembly prepare the 2014-16 budget in anticipation of lower revenues by building a large revenue reserve
  - The size of the reserve would reflect the potential use of the Revenue Stabilization Fund during the 2015 Session if the reforecast supports such action
- How would the reserve be generated?
  - Examine all new spending proposed in House Bill 30, as Introduced, not otherwise affected by the Committee amendments
  - Examine the spending included in House Bill 5002, as amended
    - HB 5002 set aside $148.8 million in a Revenue Reserve

What New Spending Proposals Were in HB 30 As Introduced

- A total of $2.4 billion in net new spending was included in HB 30
- The majority reflected updates to major budget drivers like Medicaid and K-12, with these 2 areas comprising 43% of the unadjusted new spending ($1.05 billion)
- Other areas of focus in HB 30 are listed below:
  - Improving funding for the Virginia Retirement System – both new rates and payback
  - Meeting Rainy Day Fund commitments
  - Funding health insurance increases
  - Investing in higher education
  - Debt Service
- Table on the following pages itemizes the major spending increases

2014-16 Budget Drivers
Net New Spending Proposed in HB 30

($ in Millions)	Biennial
Medicaid Utilization and Inflation	$ 557.1
Update Costs of K-12 Standards of Quality	438.5
Appropriate Deposits to Revenue Stabilization Fund	303.1
Debt Service for Projects and Equipment	196.7
Increased Funding for Higher Education	184.4
Fund Updated Costs for State Employee Retirement Rates	97.6
Fund State Employee Health Insurance Program	83.9
DOJ Settlement Agreement	56.0
Fund Payback of Deferred Retirement Contributions	53.6
Use GF to Supplement Literary Funds for Teacher Retirement	52.9
DMAS Funding for Mandatory Waiver Slots	45.3
Mental Health Funding	37.2
Targeted Salary Actions (state employees and state-supported)	35.3

2014-16 Budget Drivers
Net New Spending Proposed in HB 30

($ in Millions)	Biennial
All Other Health and Human Resources Funding	$ 36.3
Water Quality Improvement Fund	31.5
Department of Corrections Funding	31.4
599 Funding	21.3
Sheriff and Jail Funding	16.1
Economic Development Spending	19.6
Natural Resources/Agriculture and Forestry	14.3
Transportation (Port Authority)	10.0
Criminal Fund	5.4
Technology Spending	4.6
All Other Spending	84.2
Total Net New GF Spending	**$ 2,416.3**

HB 5002 Redirected New Spending To Support Committee Priorities

- In total about $347.2 million of the new spending in the Introduced budget was redirected to support Committee spending priorities
- House Bill 5002 anticipated a continued weak economy and had built in a Revenue Reserve Fund and used cash for certain capital related projects
  - A reserve of $148.8 million was appropriated for state and state supported bonus/pay raise and to fully fund the state employee VRS contribution rates at 100% in FY 2016
  - $40.4 million was allocated for a teacher pay raise in FY 2016
  - $32.5 million in cash was allocated for storm water grants and for land acquisition for a new state park

Other Committee Spending in HB 5002

- Economic Development and Natural Resources: $8.6 million for biofuel incentives, Ag BMP's and land conservation
- Judicial: $19.0 million to unfreeze judgeships
- Public Education: $20.3 million to partially restore COCA and technical adjustments for sales tax and K-3 class size
- Higher Education: $26.2 million for tuition moderation and new seats
- Health and Human Resources: $68.6 million to restore hospital inflation, mental health reform, ID/DD waivers, domestic violence

Can The Rainy Day Fund Be Used to Close The Gap?

- Once the General Assembly enacts a budget, the Revenue Stabilization Fund (Rainy Day Fund) would be available to help mitigate the impact of the shortfall
- The Rainy Day Fund cannot be used to build a budget, however, once the budget is enacted and the general fund revenues are revised downward by at least 2%, then the General Assembly, during the 2015 Session, would be able to appropriate an amount not to exceed 50% of the problem or 50% of the Fund in each of the fiscal years

Conditions Required for Fund Withdrawals

- What triggers the revenue reforecast required before a withdrawal can be made?
- § 2.2-1503.3, *Code of Virginia*, states that within 5 days of the preliminary close of a fiscal year, the Comptroller must prepare a comparison of total income (individual and corporate) and sales tax collections with the collection levels assumed in the budget
  - Generally the preliminary close occurs by about the 9th of the month
- If the comparison indicates that the total collections of such taxes are 1% or more below the official budget estimate for that fiscal year, the Governor must prepare a re-estimate of general fund revenues for the current biennium and the next biennium not later than September 1st
- If the revised forecast indicates that the difference between general fund appropriations in the adopted budget and the revised forecast exceeds 2% of prior year collections, the Rainy Day Fund may be accessed

How Much Can Be Withdrawn?

- The language governing the Rainy Day Fund limits withdrawals in any given fiscal year to either one-half of the shortfall or one-half of Fund balance
  - The estimated Fund balance after the FY 2015 deposit is anticipated to be approximately $940.0 million
- This means that in FY 2015, potentially one-half of the problem could be addressed
  - Half the Fund would be about $470.0 million
- In FY 2016, the use of the Rainy Day Fund would most likely be limited by the second measure – one half of the Fund

Beyond the Rainy Day Fund, What Other Actions Would be Required?

- As mentioned earlier, assuming the General Assembly adopts a budget prior to July 1st, then the current forecast could be used, but it would be prudent to establish a Reserve of about $800.0 million to offset the expected revenue shortfall not otherwise covered by the use of the Rainy Day Fund
- Using House Bill 5002 as amended as the starting point, about $221.7 million is easily identified by:
  - Eliminating pay raises
  - Not accelerating the VRS contribution rates in FY 2016
  - Eliminating the cash for storm water grants
- Approximately $600.0 million would still need to be identified

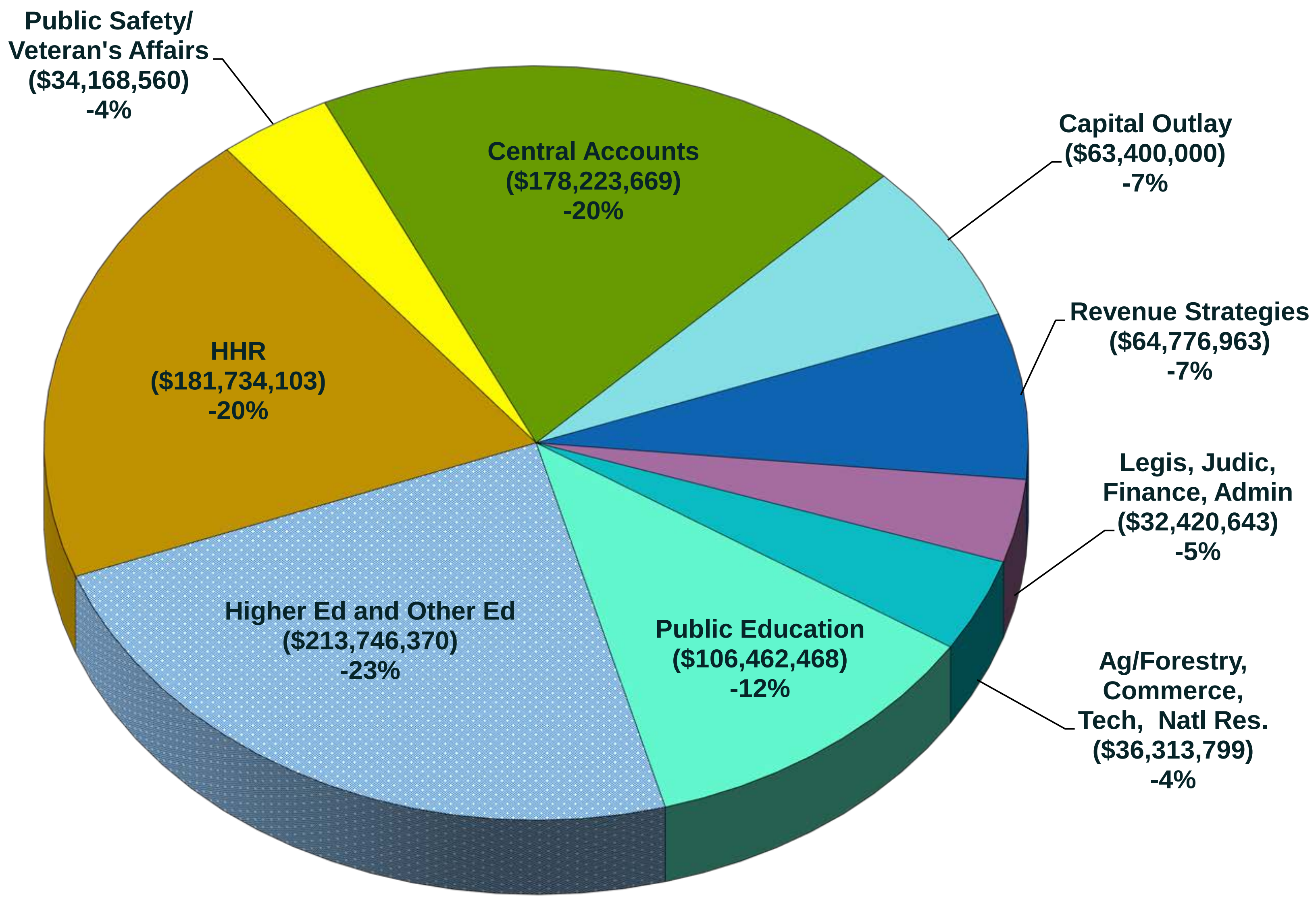
What Spending Items Would We Seek to Protect in Identifying an Additional $600+ Million of Savings?

- Virginia Retirement System contributions
- Re-benchmarking of Public Education
- Mandatory Rainy Day Fund deposit
- Debt service on already issued bonds
  - Would not halt construction
- Changes in Medicaid utilization costs

Identifying an Additional $600+ Million

- Basic premise would be to level fund the majority of state programs at the FY 2014 spending levels by examining
  - All inflation and rebasing adjustments in FY 2015 & FY 2016 for hospitals, nursing homes and teaching hospitals
  - 599 funding
  - All new funding for higher education
  - Nongeneral Fund interest earnings
  - All new tourism and economic development funding
  - All new K-12 programs
  - Sweep cash from FY 2013 capital projects and use debt
  - Delay the FY 2016 AST phase-out for 125 dealers

Potential Budget Reductions by Area Based On HB 5002



If Rainy Day Fund Cannot Be Used What Additional Programs Would Be Examined?

- If the General Assembly fails to adopt a budget by July 1st and cannot utilize the Rainy Day Fund and all other programs are on the block such as
  - Re-benchmarking for K-12 ($340.0 million)
  - Freeze construction on all new college capital projects not under bid
  - Reduce Higher Education operating support
  - Reinstitute the Aid To Local Government Reversion
  - Eliminate the new WQIF funding