The Economy … Its Impact On Virginia's Budget

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House Appropriations Committee
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True Statements

"From a technical perspective the recession is very likely over at this point."

Federal Reserve Chairman Bernanke

“The end of the recession only marks the ***trough*** in economic activity, and tells us nothing about the strength and durability of the subsequent recovery”

Jim Welsh, Welsh Money Management

“Give an economist another quarter of actual data and he will give you another forecast.”

Robert Vaughn, HAC Staff Director

A Guide To A Recession

- Recessions are determined by the National Bureau of Economic Research (NBER), an independent group of economists
- Conventional definition of a recession is 2 quarters of negative gross domestic product (GDP)
- New definition is "a significant decline in economic activity spread across the economy, lasting more than a few months, as seen in GDP, employment, real income, industrial production and wholesale-retail sales"
- Recessions apply to the U.S. economy as a whole, not to a particular state
  - Not all states are impacted the same in a recession – some states lead, others lag going into and out of a recession
  - Tax revenues generally lag the recovery due to the lagging nature of employment recovery

A Guide To A Recession

- Industrial production and corporate profits can be leading indicators of a recovery
- Job losses and gains generally lag in a recession
- Consumer spending accounts for two-thirds of total economic activity
  - Recovery cannot fully engage without consumers
- While economic indicators signal the direction of the economy, the inflection point – the point at which the recovery fully engages – is hard to predict

How Is This Recession Different?

- Is this the recession that no one saw coming -- or did they just underestimate the magnitude?
- How does this recession compare to previous recessions?
- What actions have the federal government taken spur recovery?

Where Were We?
View of National Experts in Summer 2008

- Question no longer “if” recession, but how deep and how long
  - Consensus view was a shallow recession but a protracted recovery
- Why shallow?
  - Businesses appeared to be in good financial shape
  - Feds had demonstrated willingness to do whatever necessary
- Why protracted recovery?
  - Housing was at root of problem; takes long time for housing to correct
    - Unsold inventory at record high and was still increasing
  - Consumer confidence/spending suffering – wealth effect, energy costs

View of National Experts Changed Dramatically by Late Fall of 2008

- Longer and deeper recession than originally anticipated (longest post WWII recession)
  - Financial and banking crisis continues to grow
  - Credit crunch hurts small businesses (lack of liquidity)
  - Loss of wealth and uncertainty reduced consumer confidence/spending - takes time to restore
  - Labor markets continue to shed jobs through 2010 -- unemployment could reach 10%
  - Unsold housing inventory and potential for more foreclosures continues to be a drag
- Slower growth for some time to come
  - No artificial "bubble" stimulus (dot.com or housing)
  - Growth will settle in at more sustainable long-term trends

2007 Recession
Is One for the Record Books

Recessions since World War II

		Duration in Months		Peak to Trough % Change					
Peak	Trough	Recession Peak to Trough	Expansion Peak to Trough	Real GDP	Industrial Production	Non Farm Employment		Jobless Rate	
							Low	High	Change
December 2007	**August 2009**	**20**	**73**	**-3.9%**	**-19.2%**	**-5.5%**	**4.4%**	**10.1%**	**5.7%**
March 2001	November 2001	8	120	-0.4%	-6.3%	-2.0%	3.8%	6.3%	2.5%
July 1990	March 1991	8	92	-1.3%	-4.3%	-1.5%	5.0%	7.8%	2.8%
July 1981	November 1982	16	12	-2.9%	-9.5%	-3.1%	7.2%	10.8%	3.6%
January 1980	July 1980	6	58	-2.2%	-6.2%	-1.3%	5.6%	7.8%	2.2%
November 1973	March 1975	16	36	-3.1%	-14.8%	-2.7%	4.6%	9.0%	4.4%
December 1969	November 1970	11	106	-1.0%	-5.8%	-1.4%	3.4%	6.1%	2.7%
April 1960	February 1961	10	24	-1.3%	-6.2%	-2.3%	4.8%	7.1%	2.3%
August 1957	April 1958	8	39	-3.8%	-12.7%	-4.4%	3.7%	7.5%	3.8%
July 1963	May 1954	10	45	-2.7%	-9.0%	-3.3%	2.5%	6.1%	3.6%
November 1948	October 1949	11	37	-1.7%	-8.6%	-5.1%	3.4%	7.9%	4.5%
Average		**10**	**57**	**-2.0%**	**-8.3%**	**-2.7%**	**4.4%**	**7.6%**	**3.2%**

Sources: NBER, BEA, FRB, Moody'sEconomy.com

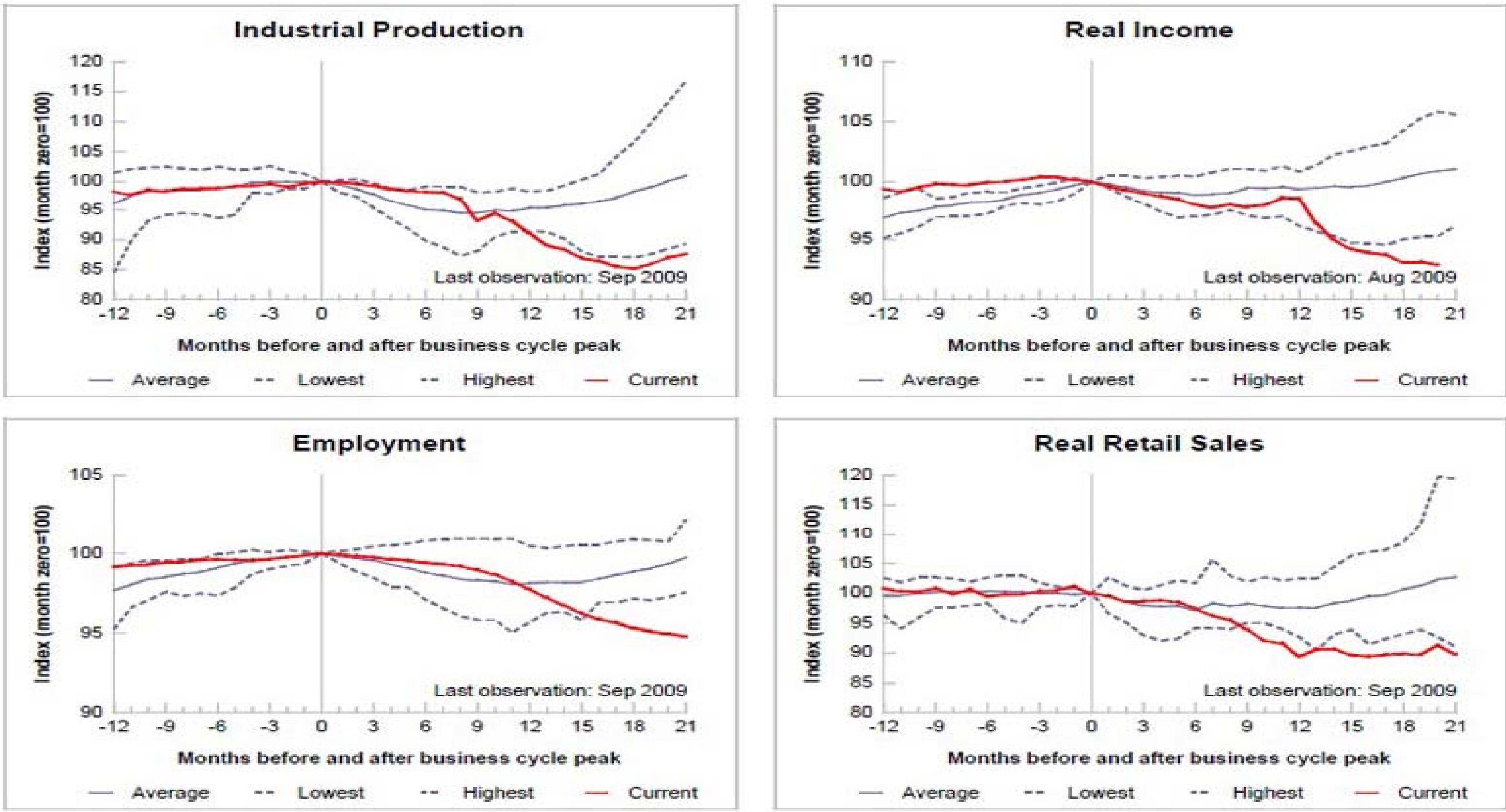
While Severe, This Is No Depression

- 1930's unemployment rate >20% for 4 years
  - As of this month, it's 10.2%
- Real annual GDP declined for 4 years during the Great Depression
  - 1929 - 8.6%
  - 1930 - 6.4%
  - 1931 -13.0%
  - 1932 - 1.3%
- In contrast, during the current recession, on an annualized basis, GDP declined only 4 quarters – the 3rd and 4th quarters of CY 2008 and the first 2 quarters of CY 2009
  - Growth was reported for GDP in the most recent quarter and is expected to continue

Key Indicators Used to Track a Recession

- These are the 4 main indicators that are used by NBER to gauge a recession
- Current recession (red line) has been worse than the average of the last 6 recessions (solid black line) for all 4 indicators
  - Dotted lines represent the best and worst of the last 6 recessions
- While employment has yet to recover, compared to the average and worst recession, it lagged nearly 12 months after the start before declining
- Retail sales on the other hand have yet to stabilize after 21 months of decline

A Look at Key Indicators Underscores the Severity…and Suggests the Consumers Are Not Quite There



Data last updated 2009-10-16.

What Actions Have the Federal Government Taken?

Federal Policy Makers Focused on Ways to Mute the Severity of the Recession

- The Federal Reserve lowered the federal funds rate to 1.00% - a historic low
  - Indications are the rate will stay in that range for the near future
  - Federal Reserve buying U.S. Treasuries to keep long-term interest rates in check
- Congress approved a $700 billion rescue for financial institutions (TARP)
  - Designed to stabilize the credit markets
- Residential Housing Act
  - Loan modification program

American Recovery & Reinvestment Act (ARRA)

- Has not resulted in a measurable increase in jobs
- Federal funding has allowed state and local governments to mitigate cuts and preserve jobs
  - Contains lots of social spending that will end in 2 years
  - "Cliff effect" for state and local governments?
- Infrastructure represents only about 15% of package
- Provided several tax policy incentives designed to spur consumer spending
  - Cash for clunkers
  - First time home buyers credit
  - Credits for energy efficient appliances/HVAC
- So, will we get a bounce?

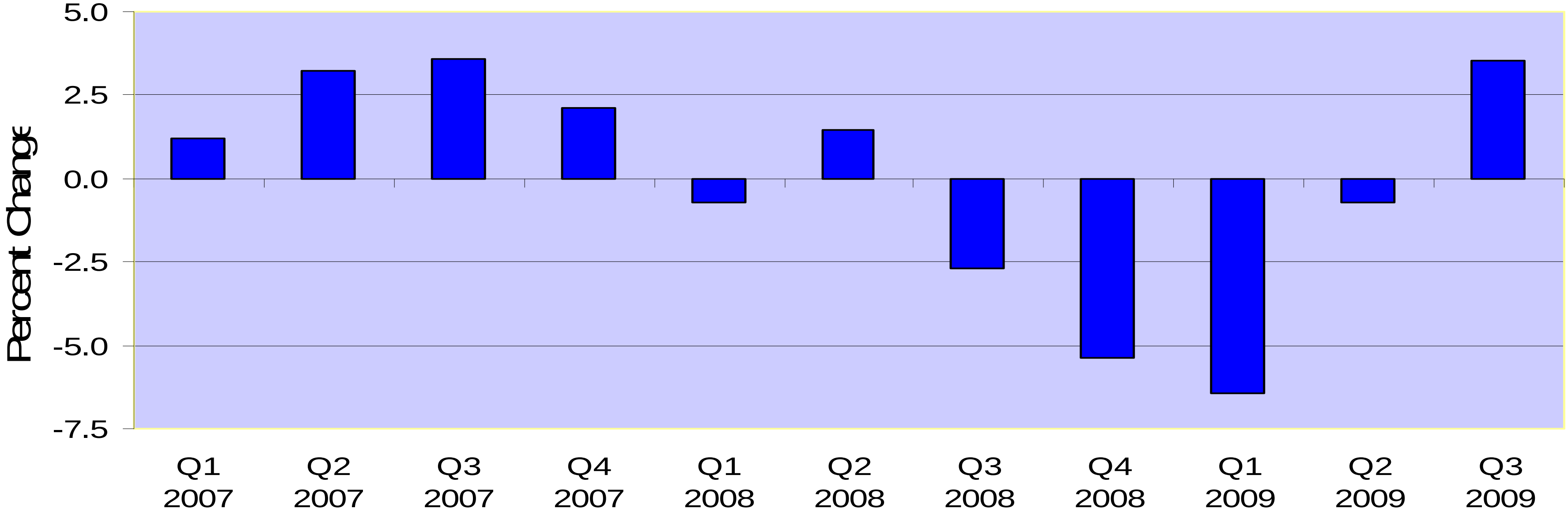
Despite Unprecedented Federal Intervention, Economists Don't Expect A Big Bounce, Why?

- Unlike at the beginning of previous recessions, the Federal Funds rate is at historic lows, standing at 1% when recession started compared to 8% in 1991 and 5% in 2001
  - Typically, once in a recession, the Federal Reserve begins to lower the Federal Funds rate in order to stimulate spending
  - Current rate limits ability to further stimulate
- In the short-term, tight credit and higher loan standards may undermine the impact of an already low Fed Funds rate
  - Unlike big companies that have multiple means to raise cash, small businesses are having a difficult time getting credit
- U.S. exports, while expected to grow, will not be robust enough to drive a strong recovery
- Recovery of job losses not expected until 2013
- Low housing demand and price declines will slow recovery
- Consumer spending will continue to be dampened due to rising unemployment, reduced wealth, and tight credit
  - Personal savings rates have increased and consumer debt is declining

The Recession Is Technically Over & GDP Is Growing – But What About:

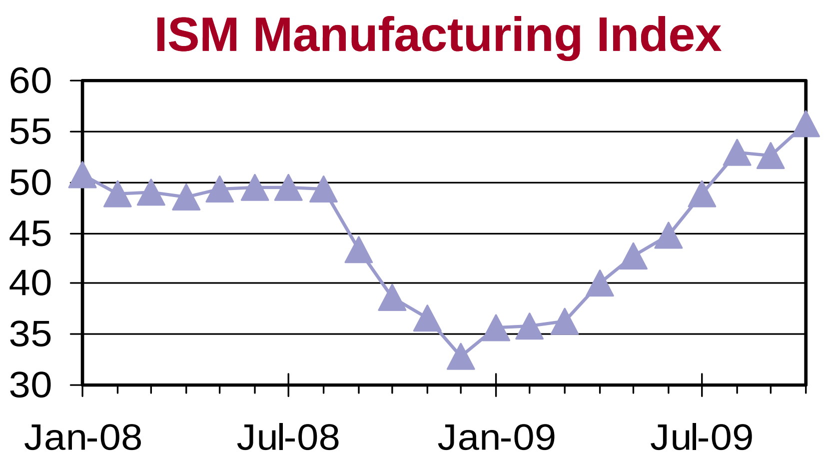
Jobs, Consumer Spending, and Housing?

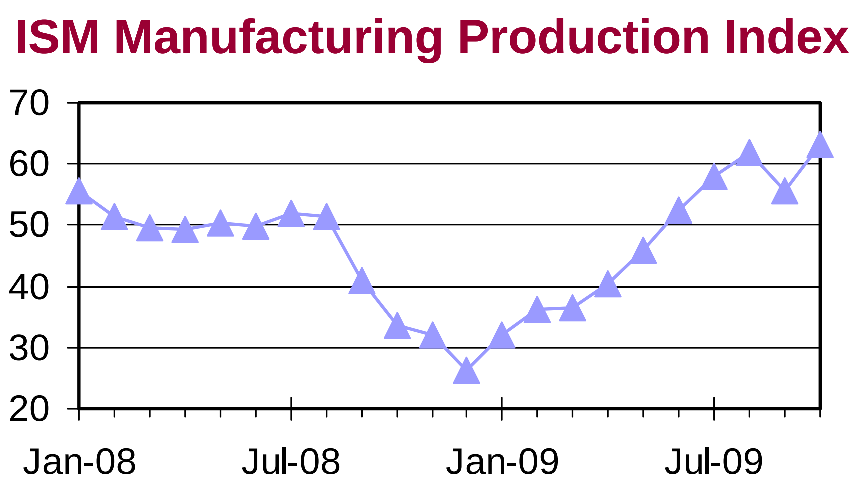
GDP Went Positive in the Third Quarter

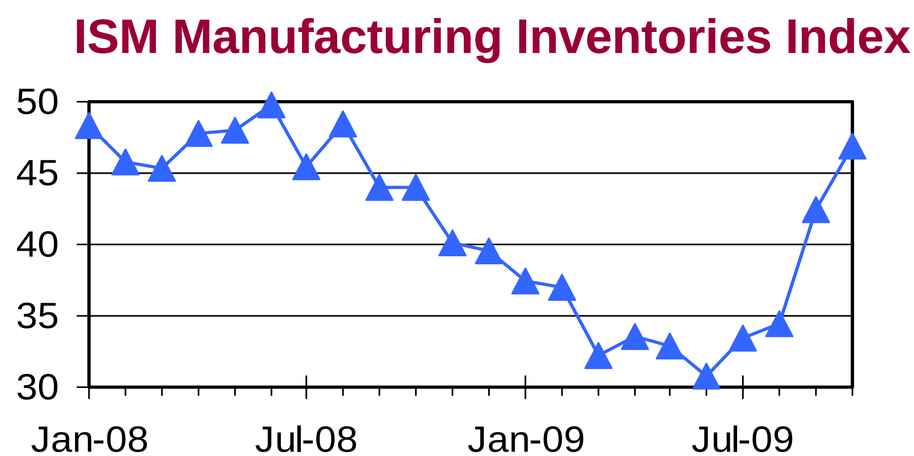


- Third quarter GDP grew 3.5%, however, the two largest contributors were durable goods and residential investment – both benefiting from short-term federal stimulus policies
  - Excluding motor vehicles, GDP grew only 1.9% on an annualized year-over-year basis
- In October, 13 of the 18 manufacturing industries reported growth, with the Institute of Supply Management (ISM) indexes showing improvement
  - Global manufacturing index also showed improvement in October, best since 2004

ISM Indexes Have Shown Signs of Improvement, Recent Pull-Backs in Manufacturing Orders Indicate that the Recovery Will Be Gradual and Uneven





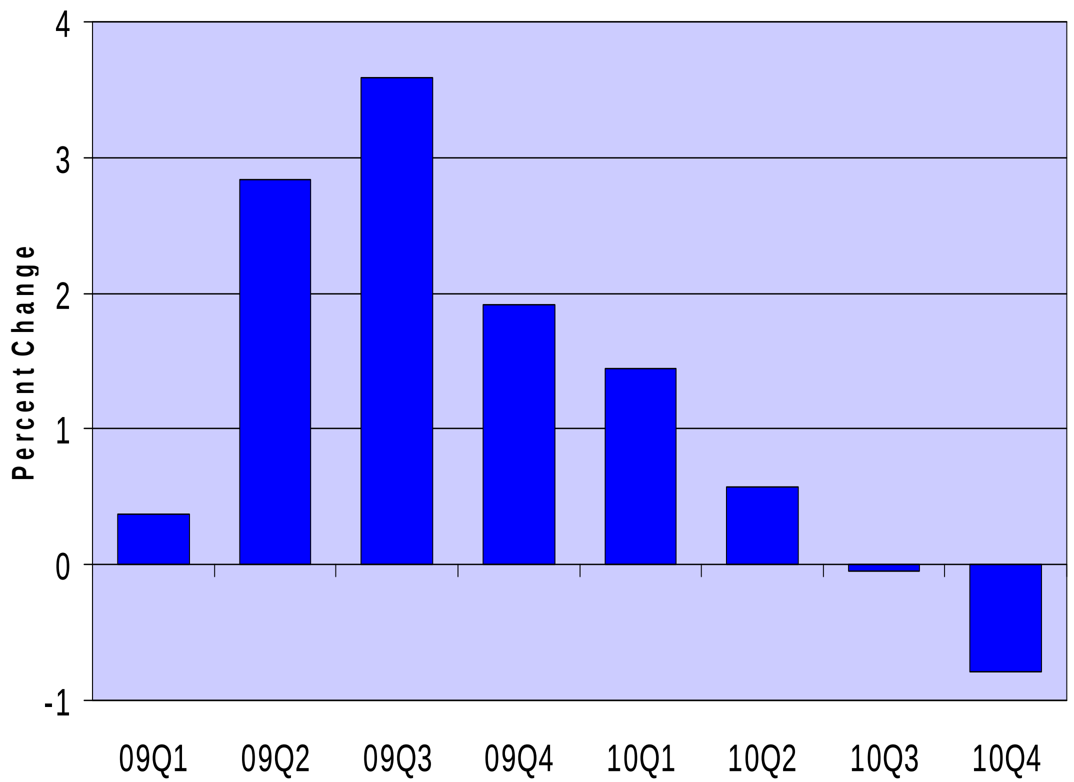


All indicators are diffusion indexes

…And Fiscal Stimulus Was Largely Responsible For This Boost

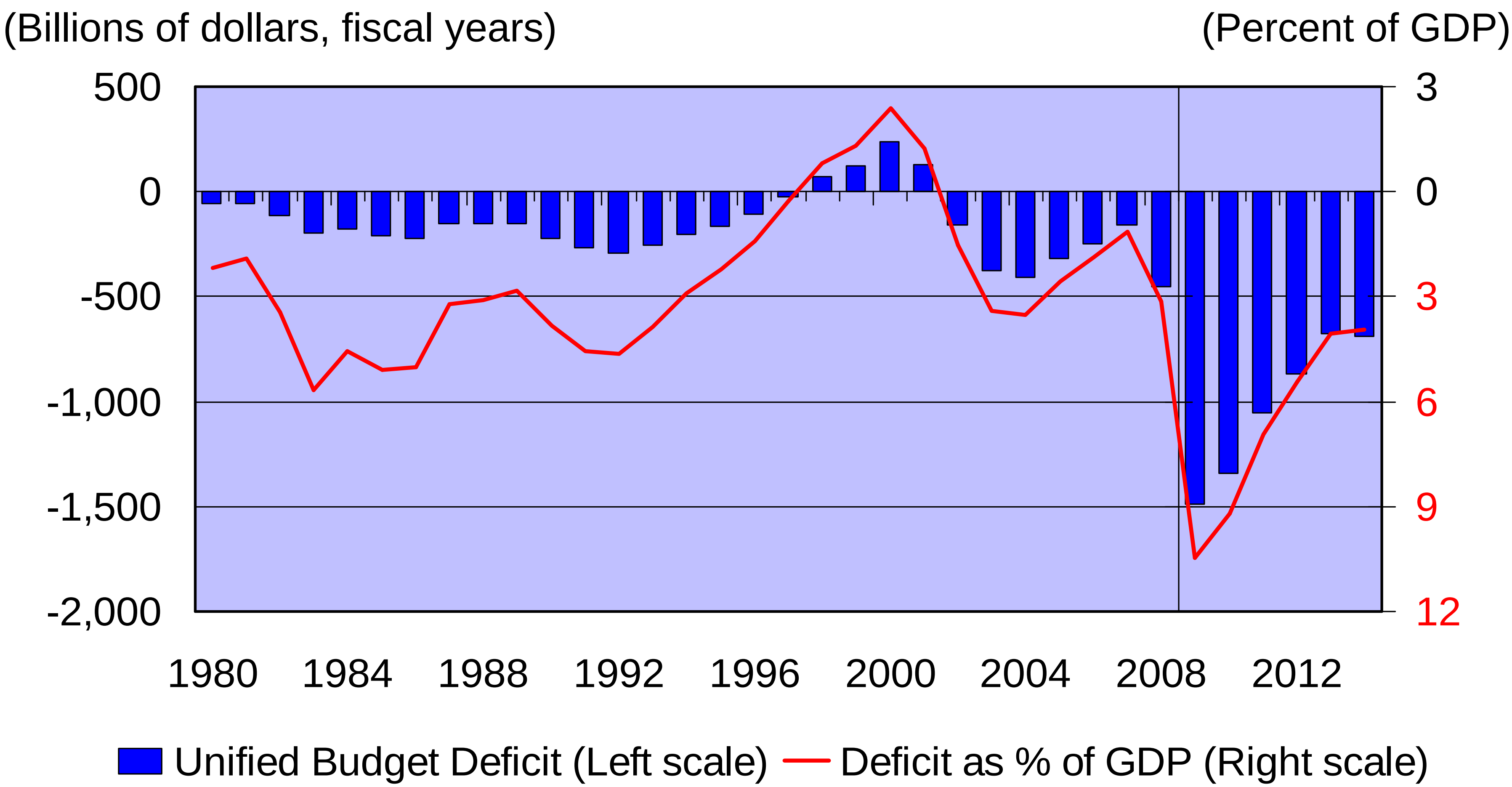
- Some question whether cash-for-clunkers and first time home buyer credit merely borrowed from future activity
- Most of the stimulus funding designed to assist state and local governments ends in FY 2011, resulting in a cliff effect and further reductions in spending
- Federal spending, while helping GDP, comes with a huge cost in terms of the federal deficit and higher interest rates in the near future

Contribution to real GDP growth, percentage points



Source: Moody's Economy.com

A Record U.S. Federal Budget Deficit in Fiscal 2009

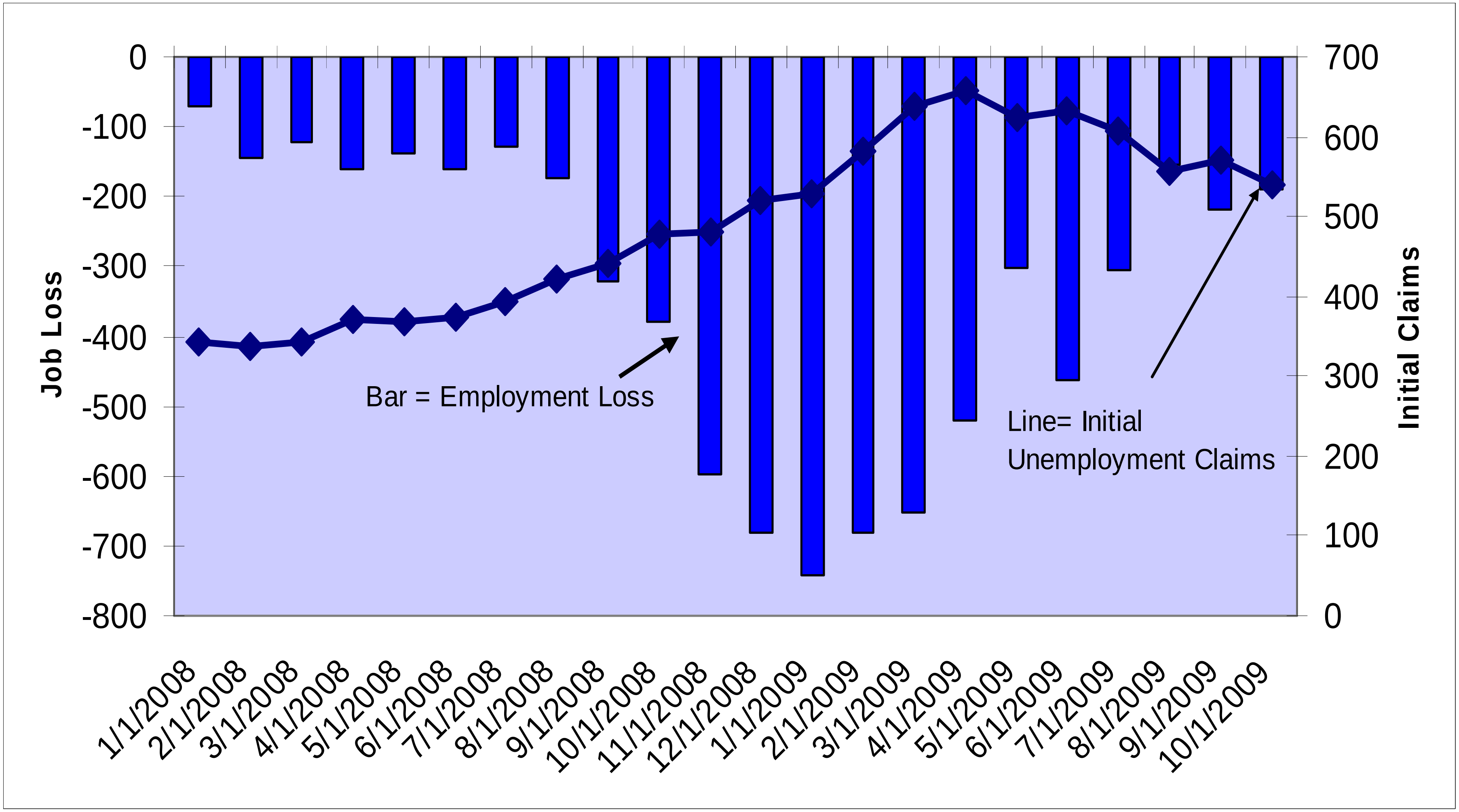


Source: Global Insight

Does the Worst Job Loss on Record Equal a "Job Less" Recovery?

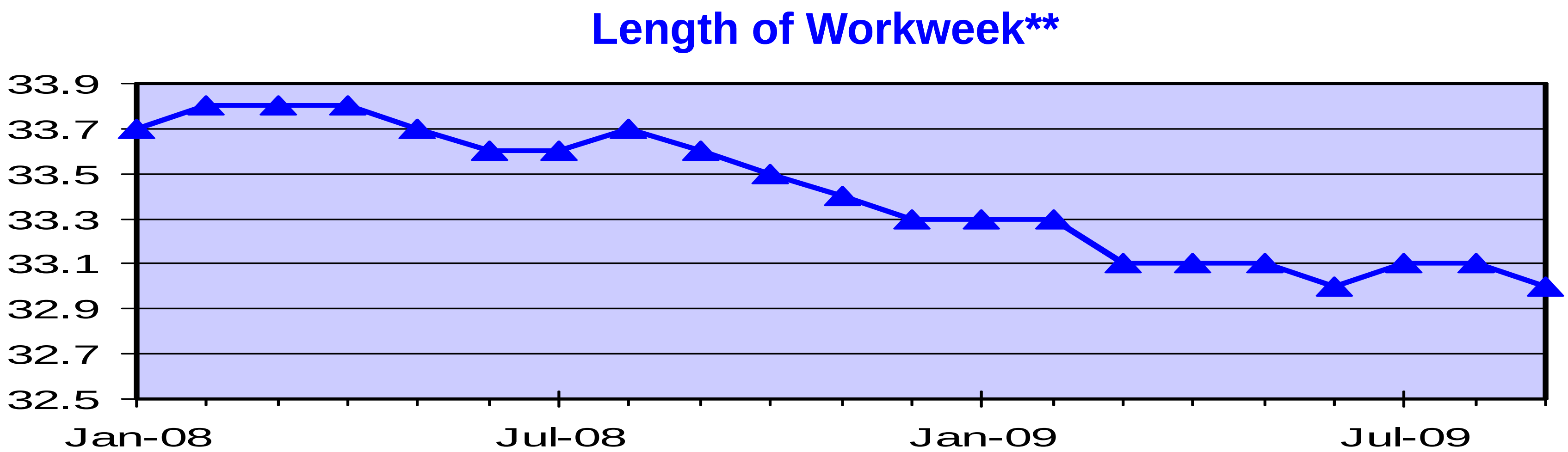
- While monthly job losses have slowed (not as many lost), the fact remains that the economy needs to create 125,000 jobs just to absorb new entrants to the labor market
- Since the recession began in December 2007, a total of 6.9 million jobs have disappeared -- if the economy created 325,000 new jobs this month, it would still take 3 years before the 6.9 million people out of work found a job
- Manpower's quarterly survey of 28,000 firms found firms are planning to hire fewer workers in the fourth quarter than in the third quarter
- Most companies will meet their additional labor needs by either increasing the hours worked per week or by adding temporary workers; the recovery of the labor market will take some time

Monthly Job Losses and Initial Unemployment Claims Have Slowed, But Look For The Unemployment Rate To Increase



Source: St. Louis Federal Reserve. Numbers in thousands representing seasonally adjusted monthly change.

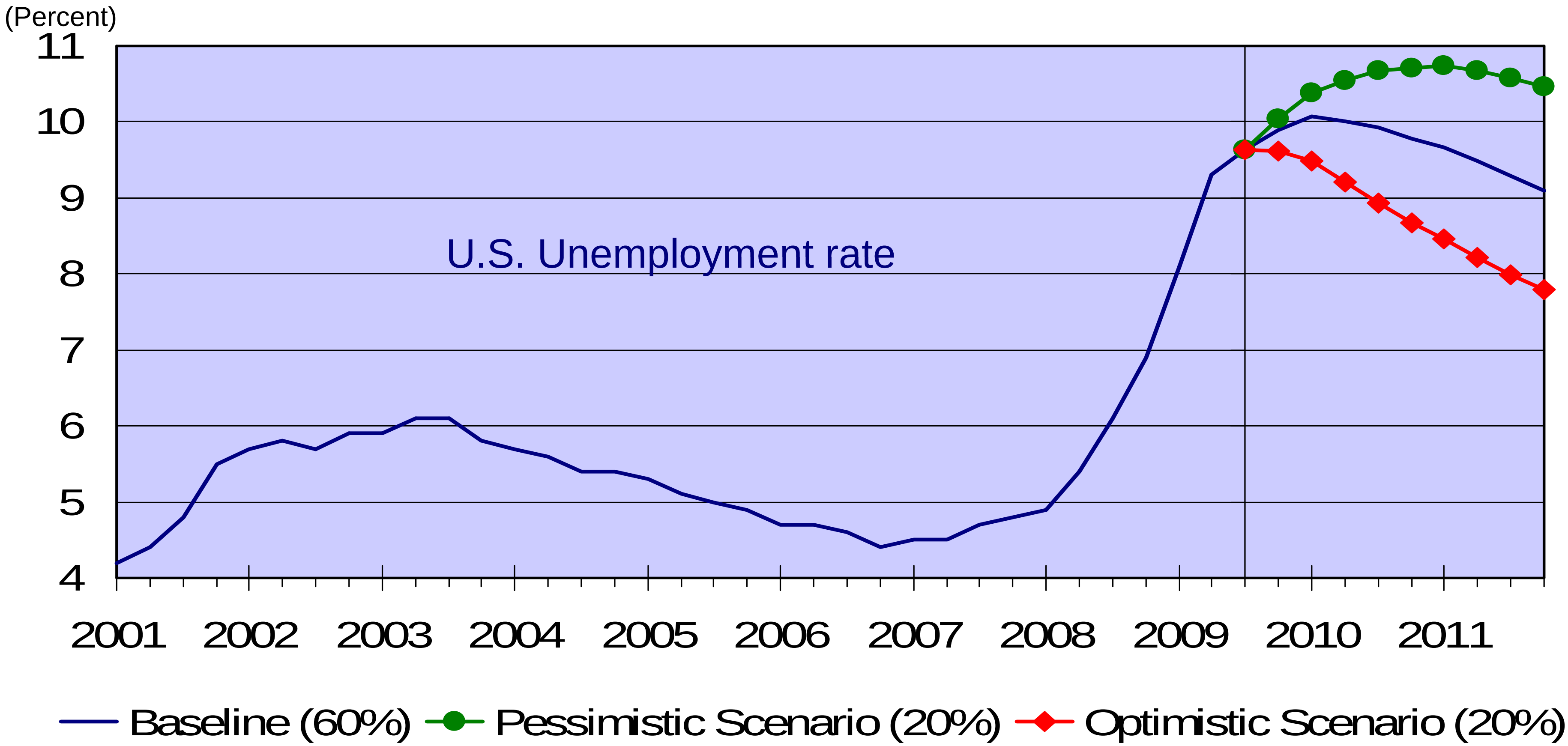
Leading Indicators To Watch That Will Signal Job Improvement Are…



*Thousands, monthly change, SA; **Hours, SA

Global Insight's Employment Outlook

- Global Insight's standard forecast assumes the unemployment rate will continue to creep up through 2010
- The alternative forecasts could be better or worse



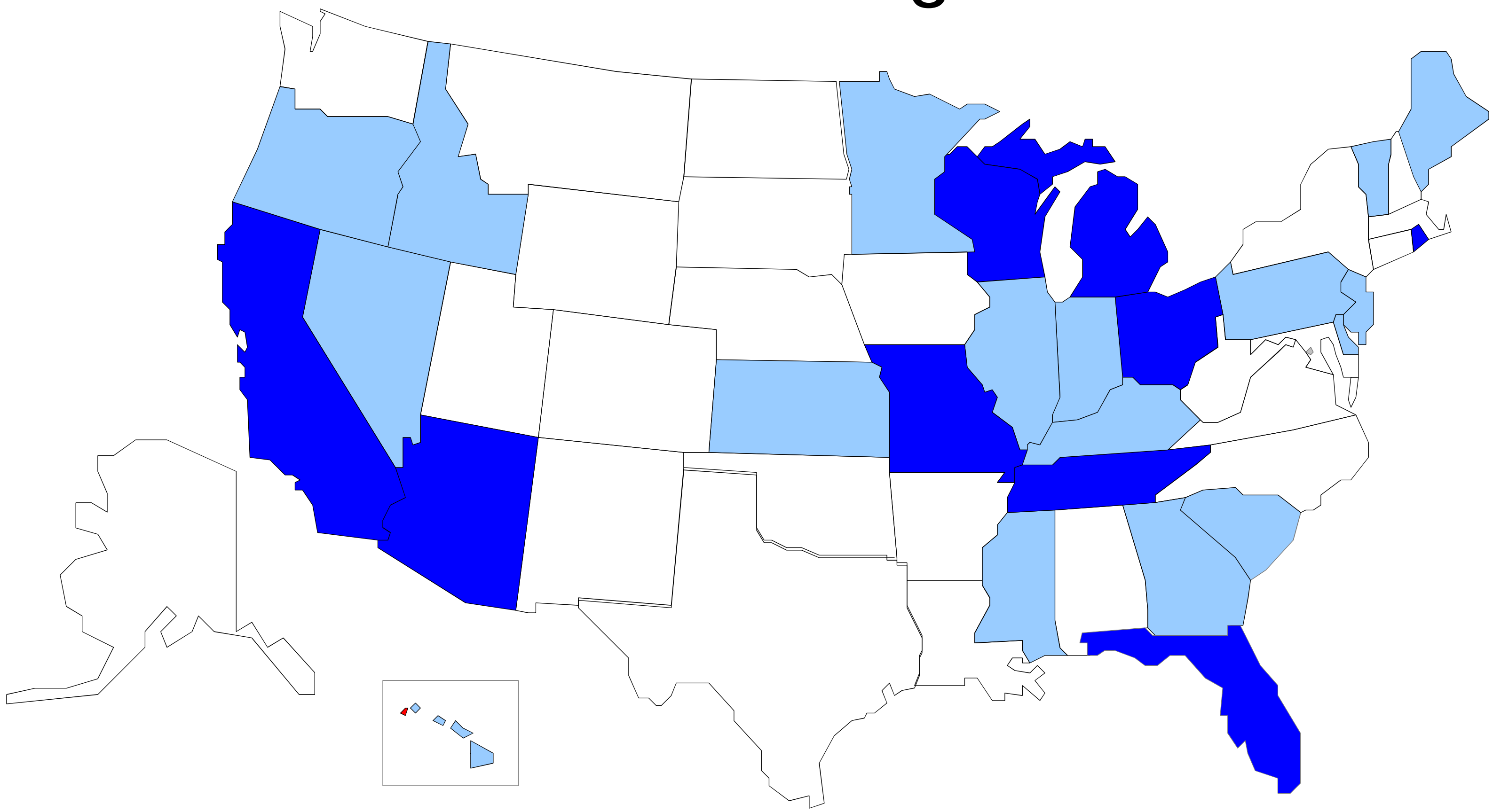
Be Glad You're Virginia

How has Virginia fared in this recession compared to other states?

Comparison of Virginia's Employment Losses to Other States

- Virginia did not begin losing jobs until August 2008 -- 9 months after the recession began
- Virginia's job losses have not been as severe as other states, with Virginia's year-over-year job losses totaling 3.05% as of September, ranking 15th in the nation
  - Using a 12-month moving average, Virginia's total job losses were 2.2%
  - 25 states have experienced job losses in excess of 4%

25 States Experienced Monthly Job Loss, Dec 2007-August 2008

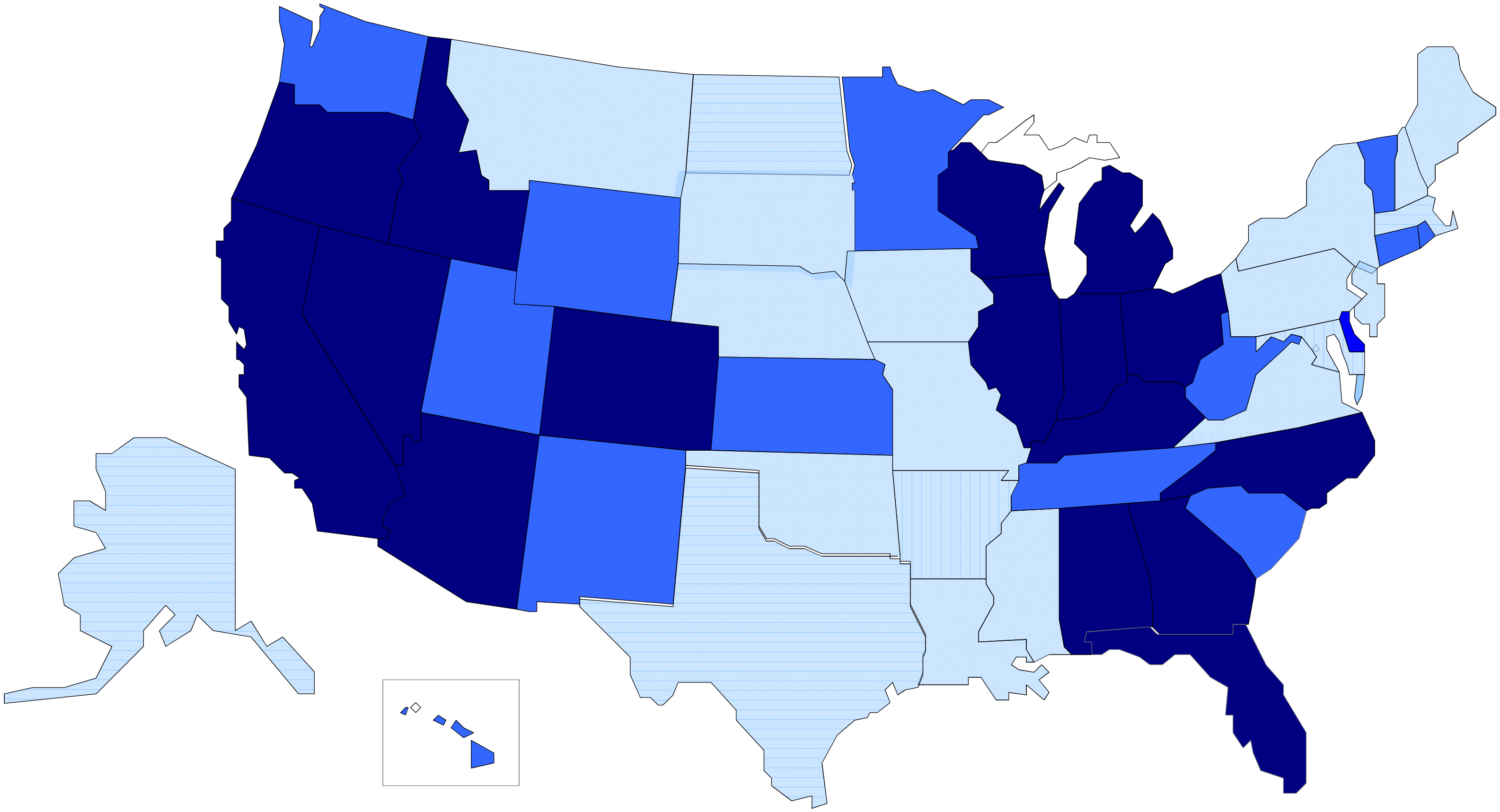


5 or more months of job loss

Job loss in 1-4 months

Source: Arizona State University, “Blue Chip Job Growth Report”.

All 50 States Experienced Job Losses September 2009 Compared to September 2008

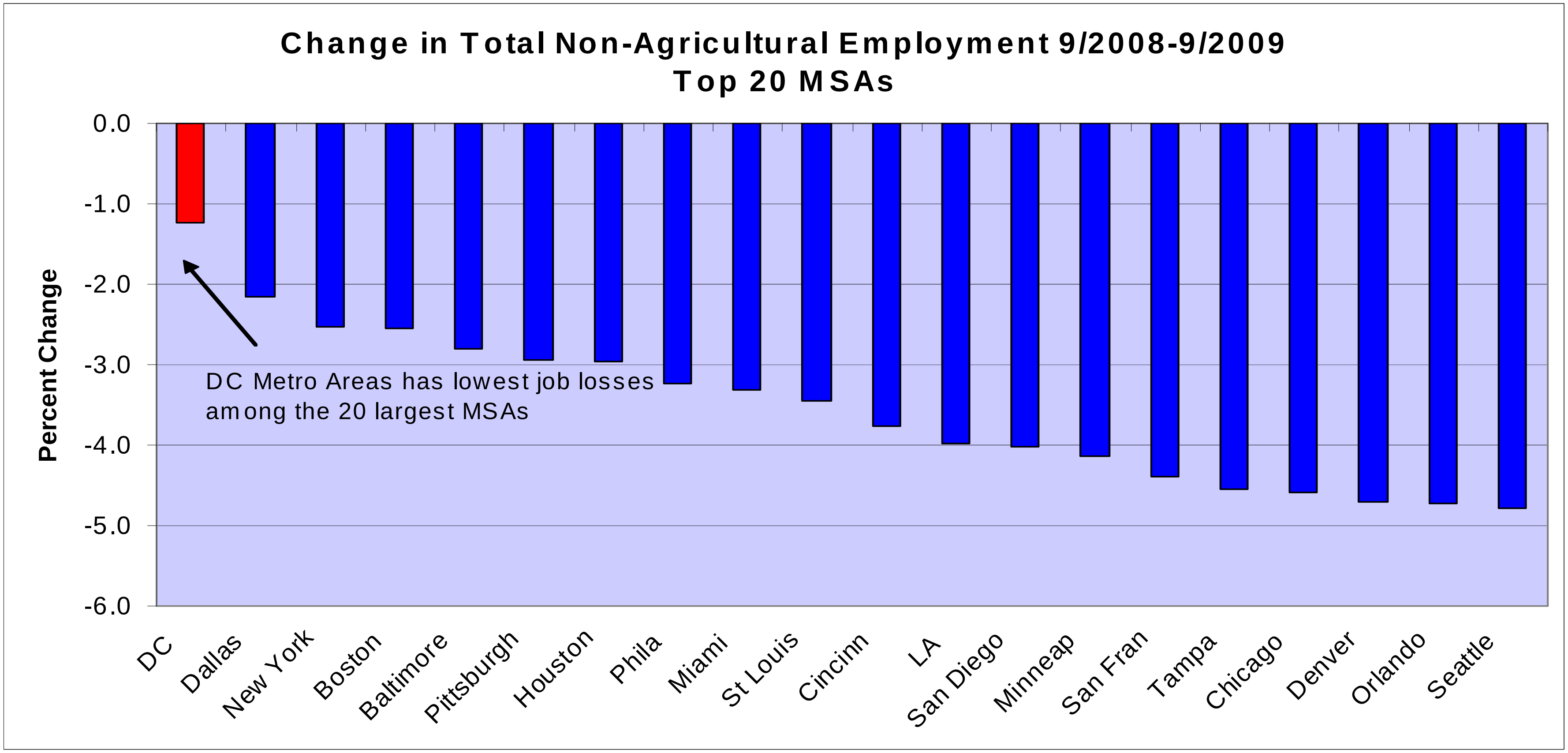


- States that have lost 0-3.5% of jobs (20 states)
- States that have lost 3.5-4.5% of jobs (14 states)
- States that have lost more than 4.5% of jobs (16 states)

US average decline: 4.24%
Virginia decline: 3.05%

Northern Virginia/Washington MSA Had the Lowest Job Loss of Any Major Metropolitan Area at 1.23%

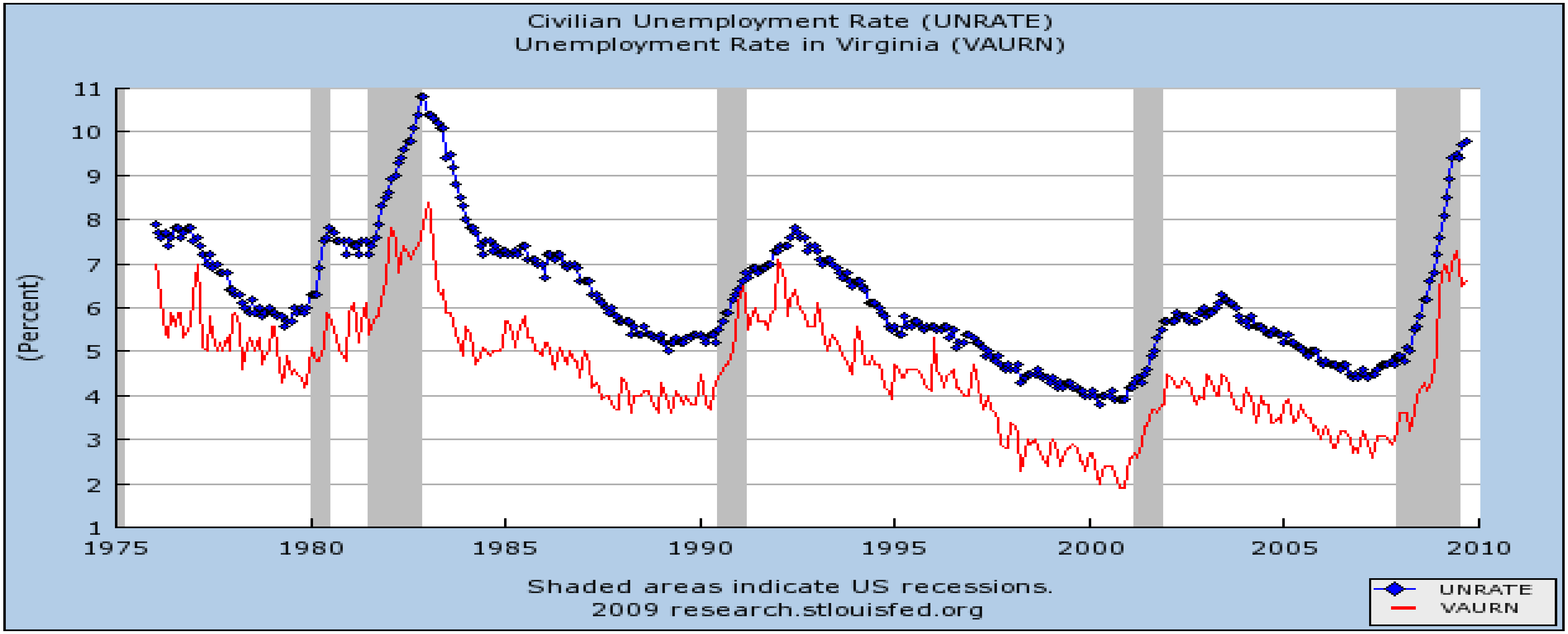
- DC area's annual job loss was 37,000, half as much as Dallas-Fort Worth, which ranked 2nd among MSA's

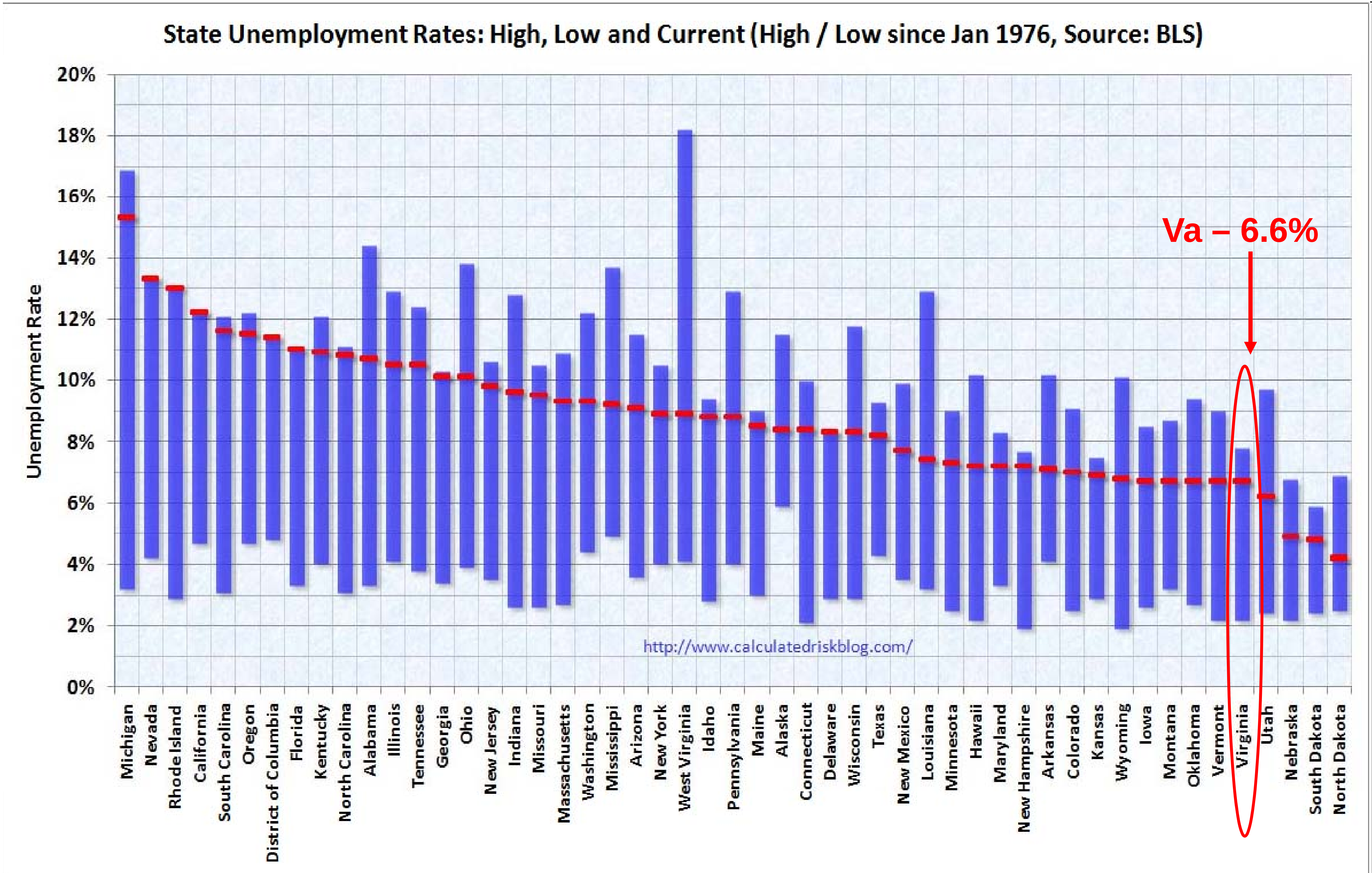


Source: Arizona State University, Blue Chip Jobs Report, October 2009

Virginia's Unemployment Rate in Perspective

- While the national unemployment rate is approaching the level of the 1982 recession – the worst in 30 years, Virginia's unemployment rate is closer to the 1991 recession rate
- Virginia's unemployment rate of 6.6% is the 5th lowest among all states, and 3rd lowest among states with over 1 million in population



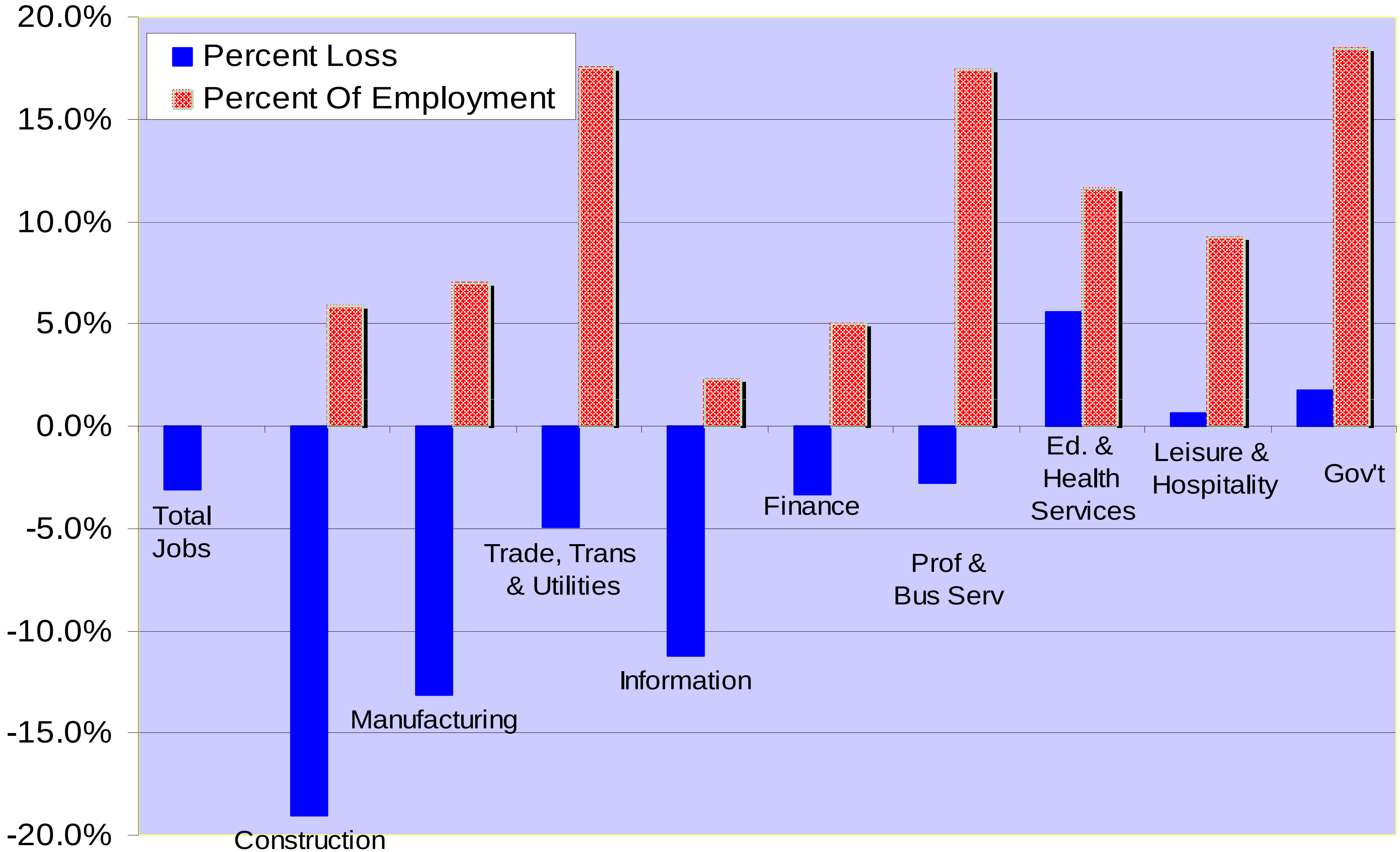


Source: Bureau of Labor Statistics

Employment Loss in Virginia

- Since 2007, Virginia has lost over 118,000 jobs, 70% (82,500) of them in construction and manufacturing, which together comprise 12% of our total workforce
  - Manufacturing has been losing jobs since the last recession with 60,000 jobs lost since 2004
    - Most of these jobs will not come back due to plant closures
  - Construction employment peaked in 2006
- Jobs in professional and business services (18% of the workforce) accounted for 62,000 or 38% of the state’s total job growth from 2004 through 2007
  - Accounts for less than 3% (18,000) of jobs lost since 2007

Percent Job Loss Since 2007 by Industry as Compared to Percent of Total Employment



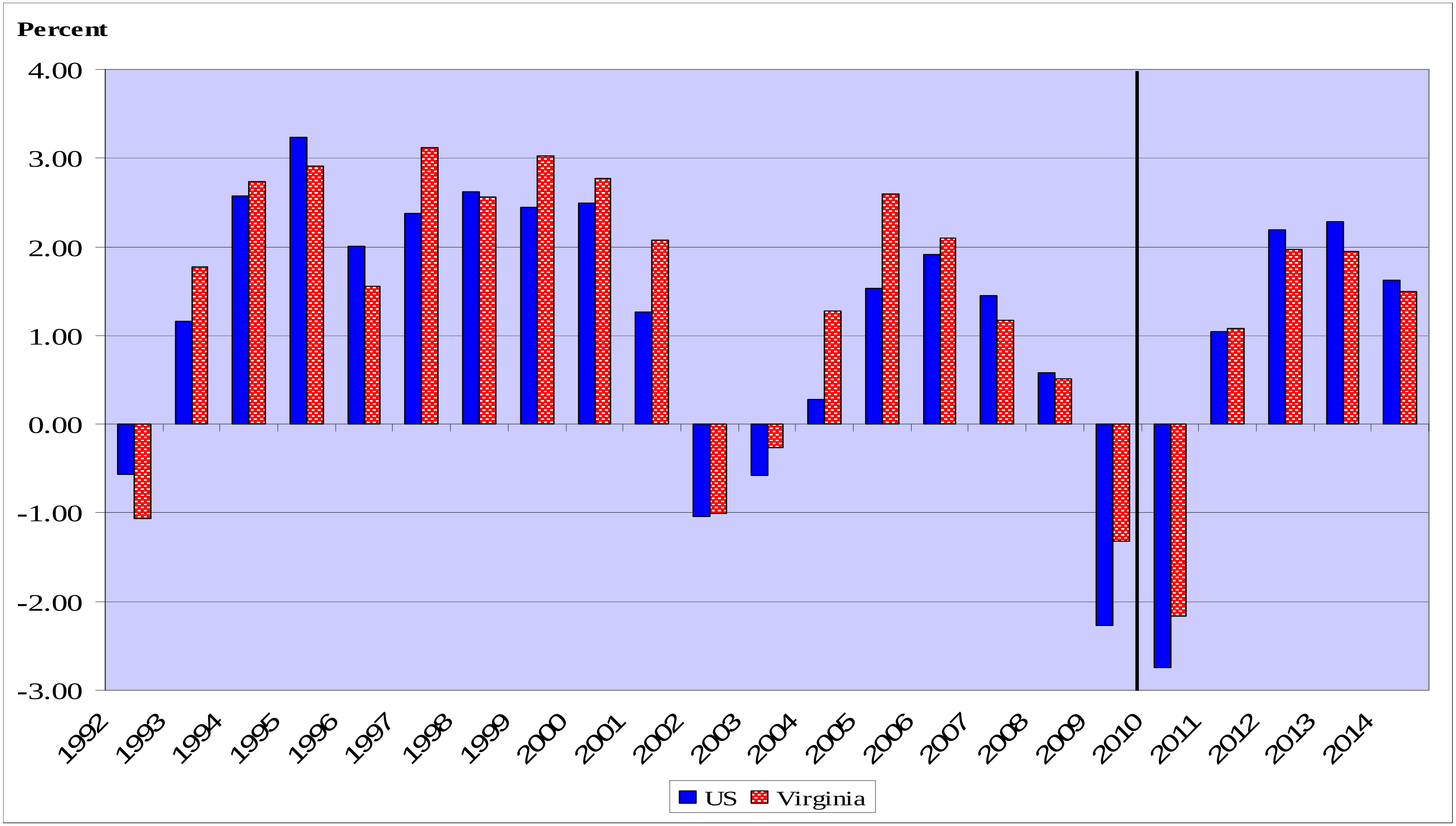
Virginia's Employment Outlook

- Virginia typically out-performs the nation in employment growth, however, based on the August economic outlook, job growth in Virginia during the next biennium is expected to perform at, or slightly below, the nation as a whole
- This is due in part to several factors:
  - We have not shed as many jobs as other states
  - We have a low unemployment rate relative to other states
  - Professional and Business Services represents nearly 18% of total employment, and has not suffered the same rate of job loss
  - Virginia's manufacturing employment is less than 7% of our total jobs compared to 10% for the nation. As the economy improves, manufacturing employment typically experiences stronger job growth
- For the current fiscal year, economists expect that Virginia will continue to shed jobs, albeit at a lower rate than the nation. The majority of losses are expected to be in building-industry related employment (construction, financial) and manufacturing employment
- On the positive side, Virginia continues to attract new companies, along with some expansions of existing companies

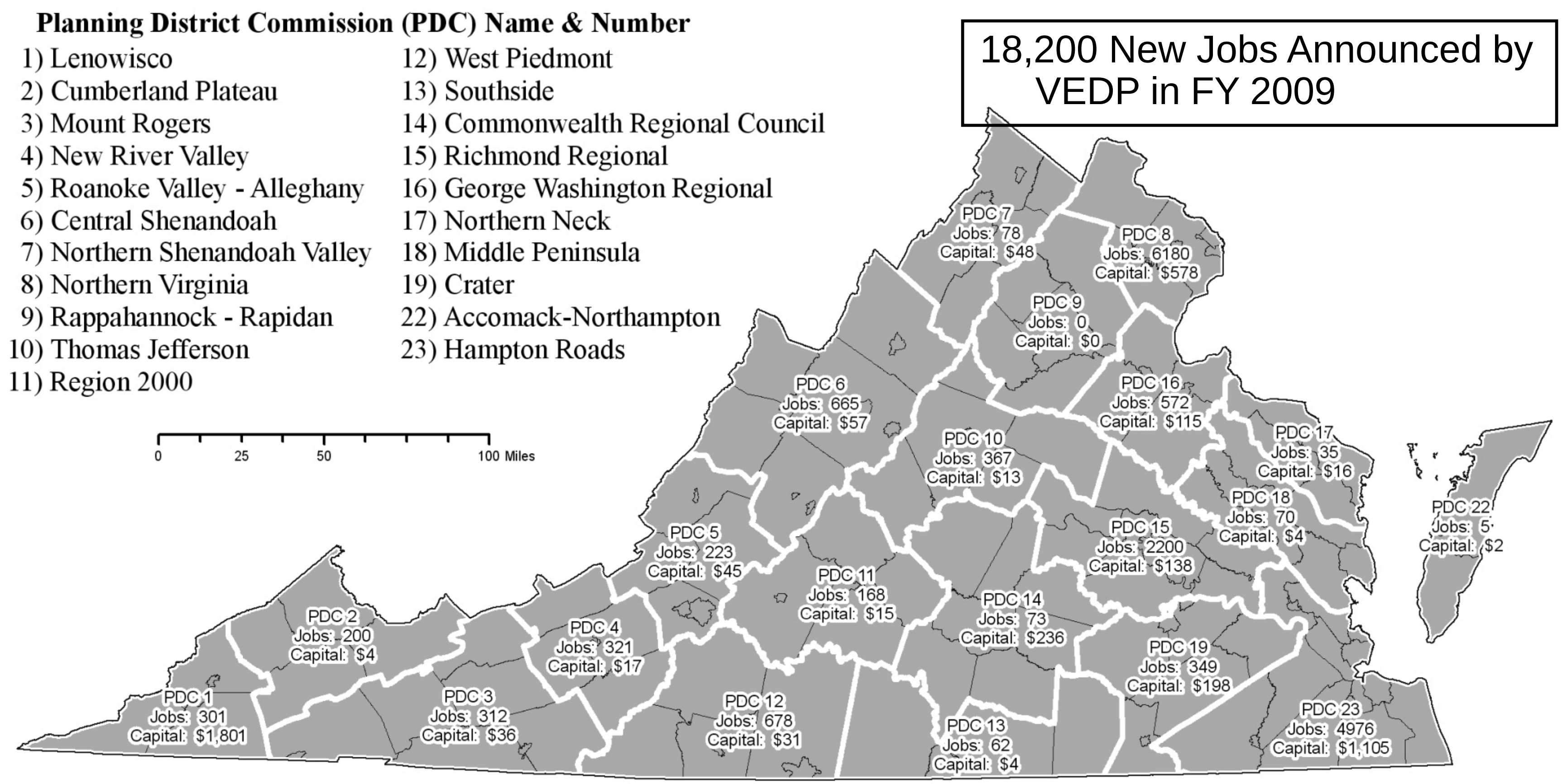
US and Virginia Employment Growth

FY 1992-09 Actual and FY 2010-12 Forecast

Annual Percent Change



Employment Creation and Capital Investment by Planning District
Fiscal Year 2009



Numbers on map indicate jobs created and capital invested in millions for FY2009. All announcements are subject to revision.

Map created by Virginia Economic Development Partnership, September 2009

Impact of Consumer Spending and Housing Crash on the Economy

Consumer Spending

What is Needed to Spur a Real Recovery?

- First and foremost, a turnaround in consumer spending, which accounts for two-thirds of economic activity
- During previous recessions, consumer spending remained on the rise or contracted slightly for only one year
  - During 2001 and 2002, spending grew between 1% and 2% each year
  - During the recession in the early 90s, it contracted by 1% for one year
- But this recession has been more toxic on the consumer side of the equation than had been predicted
  - Last fall, Global Insight was projecting national consumer spending <u>growth</u> of 0.4% in CY 2008 and 0.2% in CY 2009
  - Consumer spending fell in CY 2008 and is expected to decline by an even larger percentage throughout CY 2009, before growing slowly next year

Virginia Sales Tax Collections Showed Record Deterioration in FY 2009

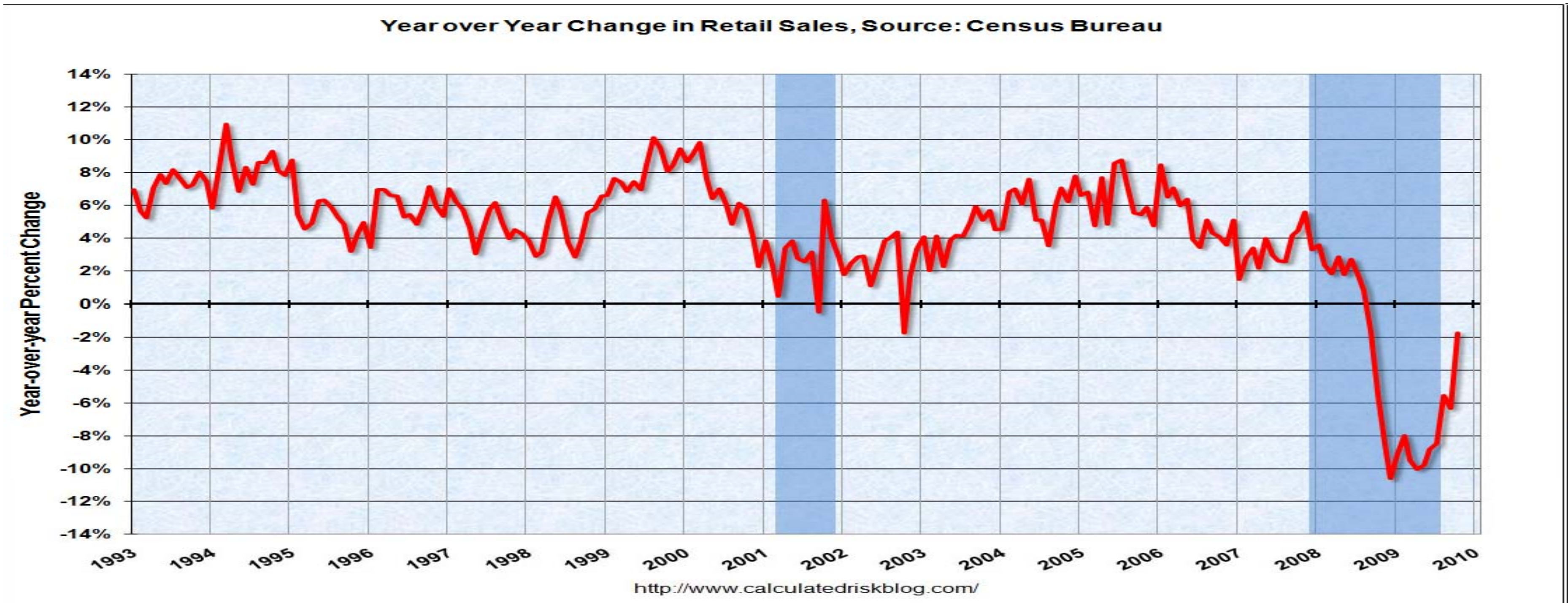
- Last year Virginia's sales tax collections fell even more dramatically than consumer spending, declining 5.6% in FY 2009 – the largest annual decline on record
- This was the first year sales tax collections have fallen since 1991, when they dropped a comparatively small 1.1%

Sector	# of Firms	FY08	FY09	% change
Housing	157	$465.5	$405.4	-12.9%
Warehouse Clubs/Supercenters	6	369.7	375.2	1.5%
Department Stores	111	375.5	348.3	-7.2%
Grocery Stores	19	288.7	298.6	3.4%
Retail Trade	94	232.6	233.2	0.3%
Restaurants	71	124.0	120.9	-2.5%
Wholesale Trade	68	63.6	52.0	-18.3%
Gasoline Stations	17	48.2	47.3	-1.8%
Other	300	228.5	203.9	-10.7%
Total	**843**	**$2,196.3**	**$2,084.9**	**-5.1%**

- Table above represents sales at our largest remitters, making up about 2/3 of total collections
- Housing-related taxable sales (20% of total) continued to lead the weakness in FY 2009, declining 12.9% from FY 2008
- Taxable sales from department stores and restaurants (23% of total), two sectors dependent on discretionary spending, declined 6.1% from FY 2008
- When adjusted for higher food prices, even sales at grocery stores, warehouse clubs, and supercenters (31% of total) were below FY 2008 levels

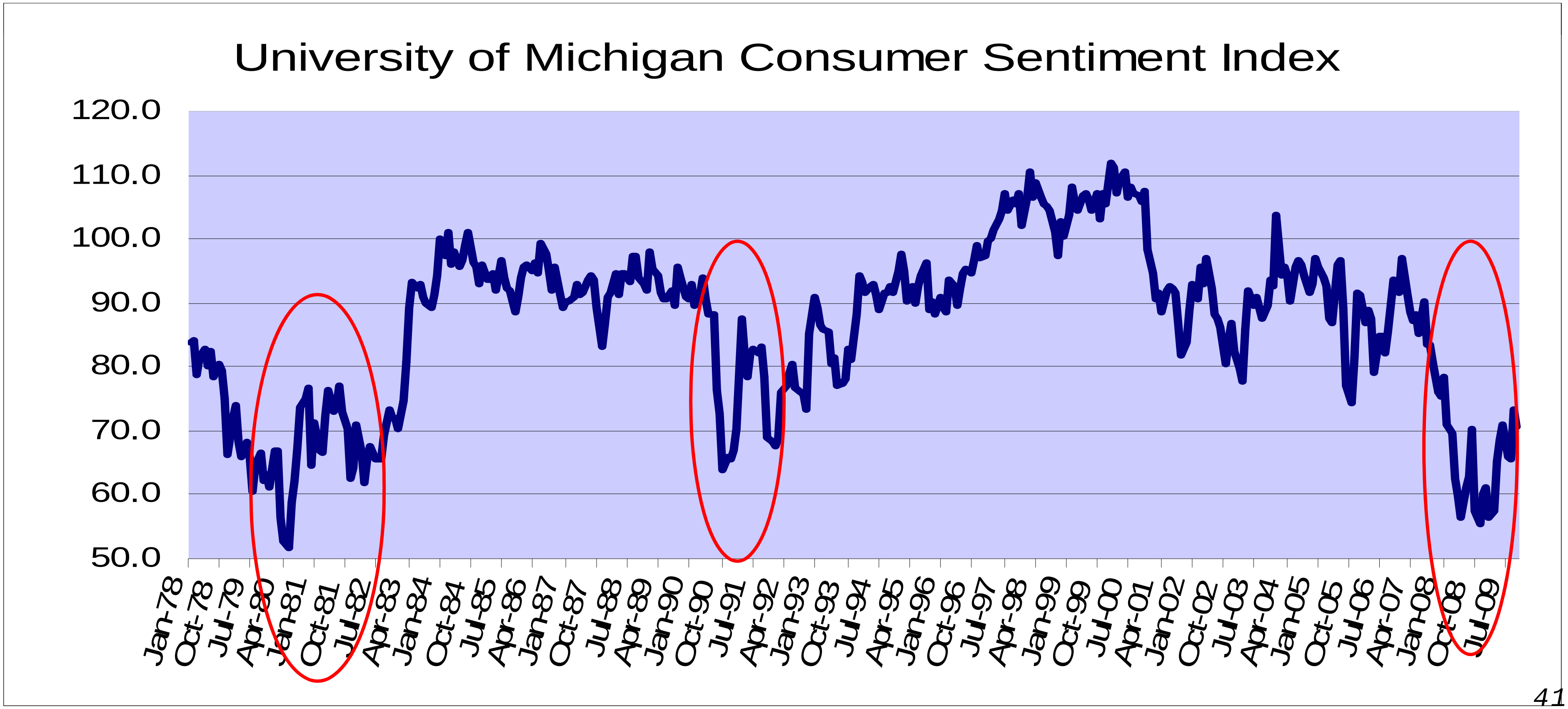
Nationally, Retail Sales May Have Reached Bottom, But Are Still Negative

- There are signs that the freefall in sales has abated, but while sales have stabilized there has been no steady trend toward improvement
  - Since December, retail sales have bumped slightly up and down on a monthly basis but are still negative on a year-over-year basis
- On a monthly basis, seasonally adjusted retail sales increased 1.4% in October after declining 1.5% in September, and are off 2.6% compared to September 2008
- In Virginia, sale tax collections were down 5.8% on a year-over-year basis through October, compared to an economic forecast of -4.1%



Plummeting Consumer Confidence Has Ended, But…

- October consumer confidence report pegged confidence up about 12 points since last year, but down from the previous month
- Confidence still hovers at levels equal to the low point during the 1990s recession; the only other time it has been in this range was the early 1980s
- In October - for the 13th month in a row - a majority of consumers reported that their personal finances had worsened; this is the longest and deepest decline in the history of the index

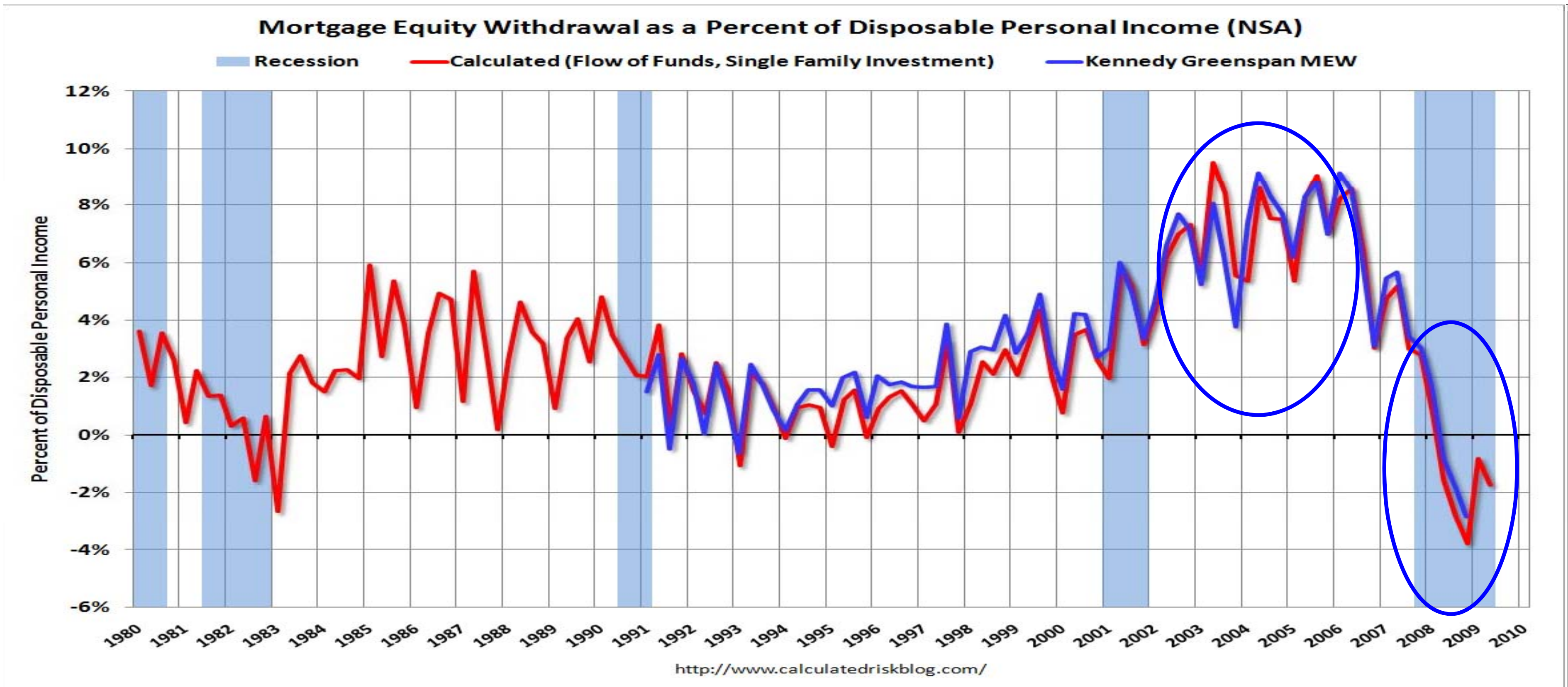


Will Stabilization Lead to a Bounce?

- If the recession is officially over, and consumer spending and confidence have reached bottom, when will we see improvement?
- Typically, economic recoveries are driven by resurgent spending on homes, vehicles and other large purchases – pent-up demand that is unleashed as soon as a recovery begins
- No one expects that to happen
  - Economists hope for 1.6% growth in total personal consumption expenditures in CY 2010
  - This is well below trend growth and far from a V-shaped recovery
- Why is it different this time?
  - For the first time in 60 years, the majority of families expect their incomes to remain unchanged or decline in the next year
  - According to both polling data and economic statistics, consumers are now placing debt reduction and increased savings at the top of their agendas – not resumption of deferred expenditures

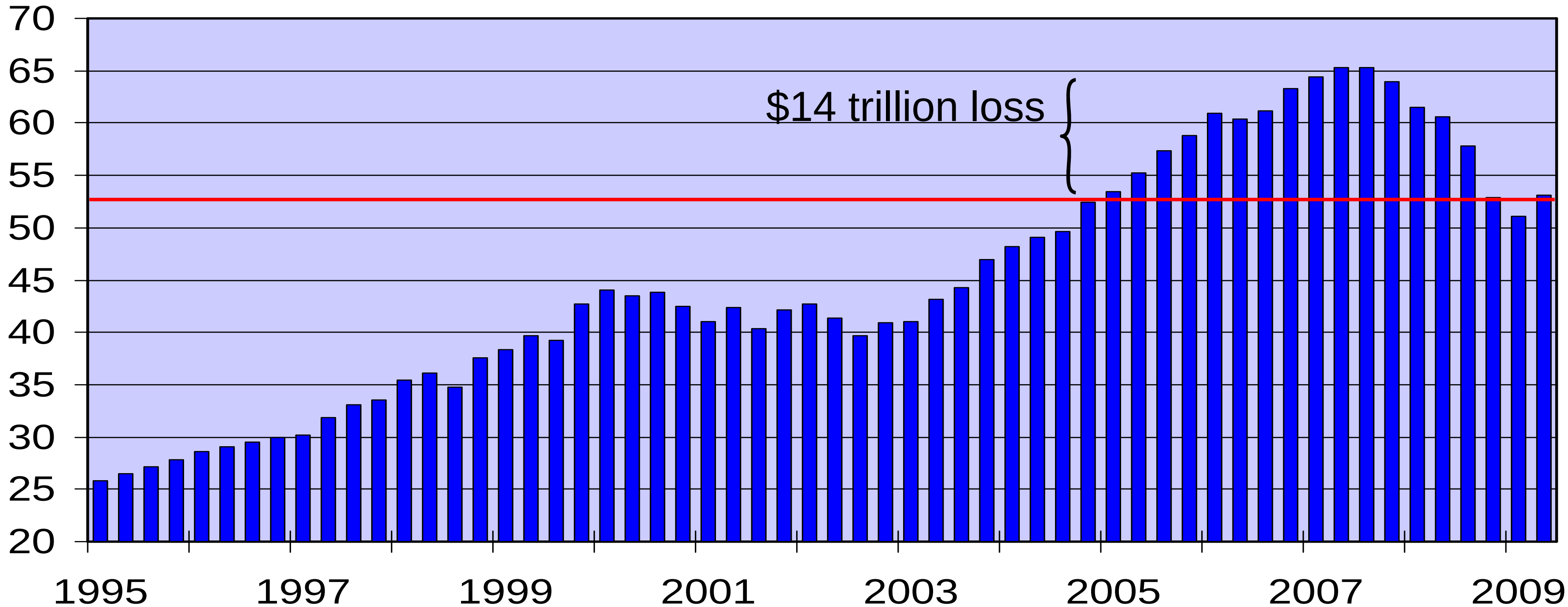
Home ATM Has Closed

- During the housing boom, mortgage equity extraction substantially boosted total consumer spending
  - Equity extraction made up in excess of 8% of total disposable income in the 2004-06 timeframe; in recent quarters it has fallen to -4% as homeowners pay down equity lines and/or are ineligible for further loans

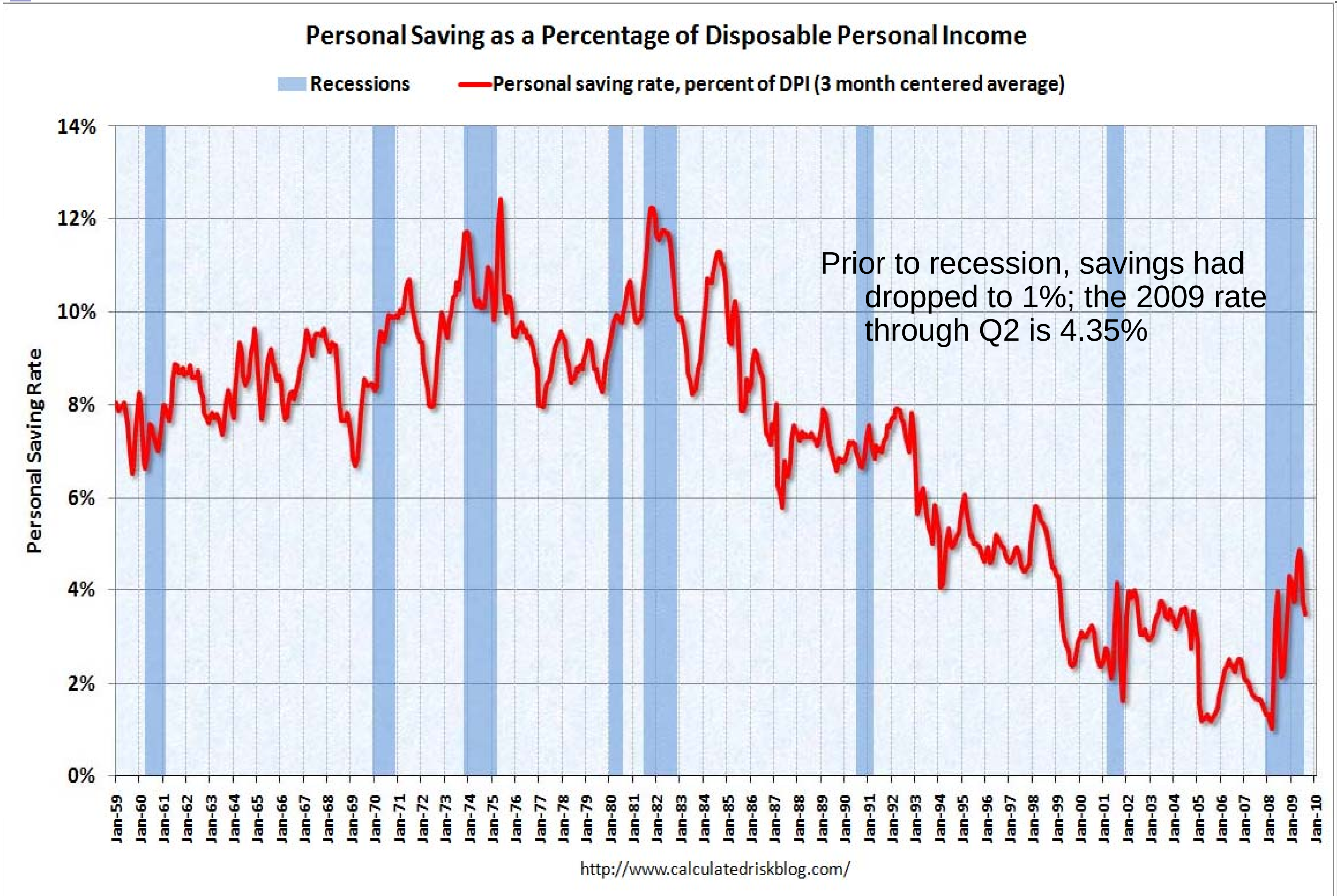


Loss of Household Net Worth: Climbing Out of a Hole

- It is estimated that since the peak in the second and third quarters of 2007, household net worth has declined by $14 trillion, putting wealth back at late 2004 levels
  - This reflects both steep declines in housing values and losses in the stock market



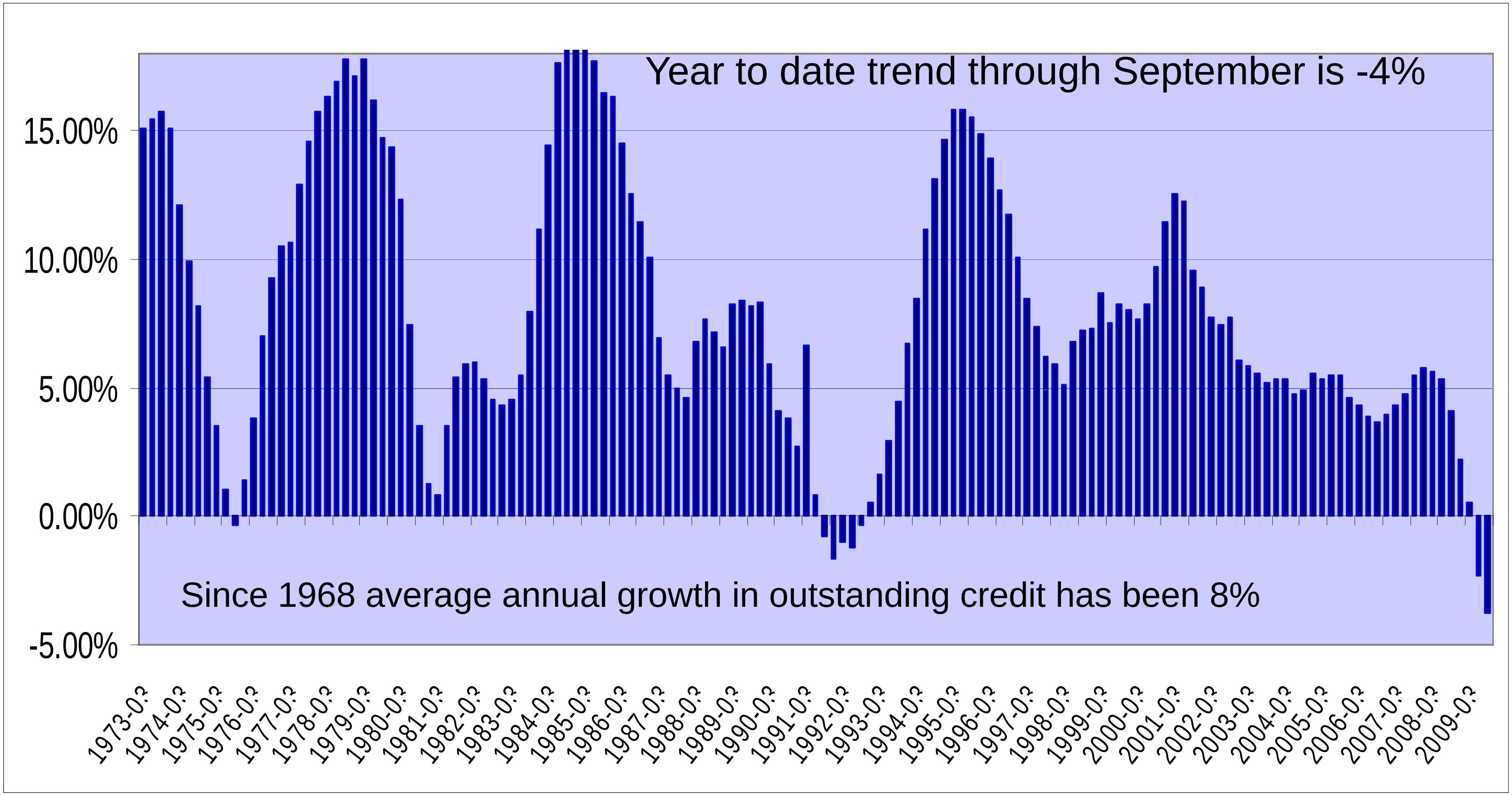
Source: Global Insight



Source: Bureau of Economic Analysis

Percent Change in Outstanding Consumer Credit

(Year over Year, 3-Month Average)



Source: Federal Reserve. Consumer credit includes all revolving and non-revolving credit exclusive of home loans.

What Will it Take To Spur Spending?

- In the short term, spending will continue to be hampered by:
  - Continued fear of job loss in the face of one of the highest unemployment rate in decades
  - Flat or declining income levels
  - Lack of access to credit
  - Dramatically decreased home equity “wealth” and concern that home prices have yet to hit bottom
- Before we see a marked increase in spending consumers require some stabilization of the job market and feeling of security about their personal finances
- While trends to reduce outstanding debt and increase savings hamper spending in the short run, they help support long-term economic health – the housing bubble couldn’t sustain growth forever
  - Historically, growth in household debt preceding a financial crisis is the primary driver of the onset and deepening of a recession

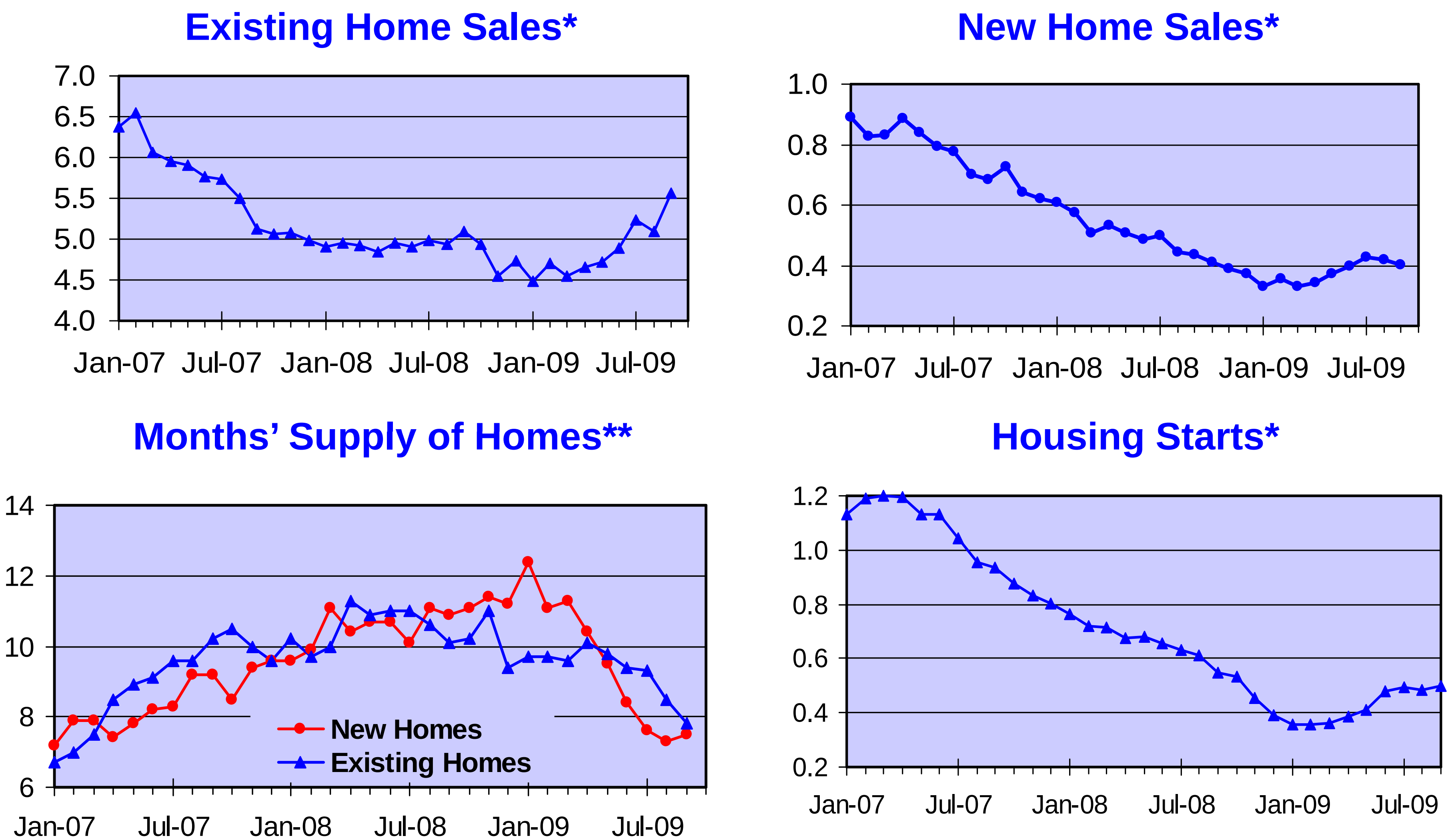
Impact of Consumer Spending and Housing Crash on the Economy

Housing

Housing Shows Some Signs of Recovery

- Since peaking in the third quarter of 2005, home sale volumes in Virginia and across the nation fell to levels not seen in more than a decade
- Although housing starts remain at decade lows, foreclosures continue to increase, and price declines continue in most areas, we are seeing a stabilization in sales volumes and a flattening of price declines
- Do trends in key housing indicators point to a recovery?
  - Housing starts
  - Sales volumes
  - Inventory levels
  - Foreclosures
  - Home prices

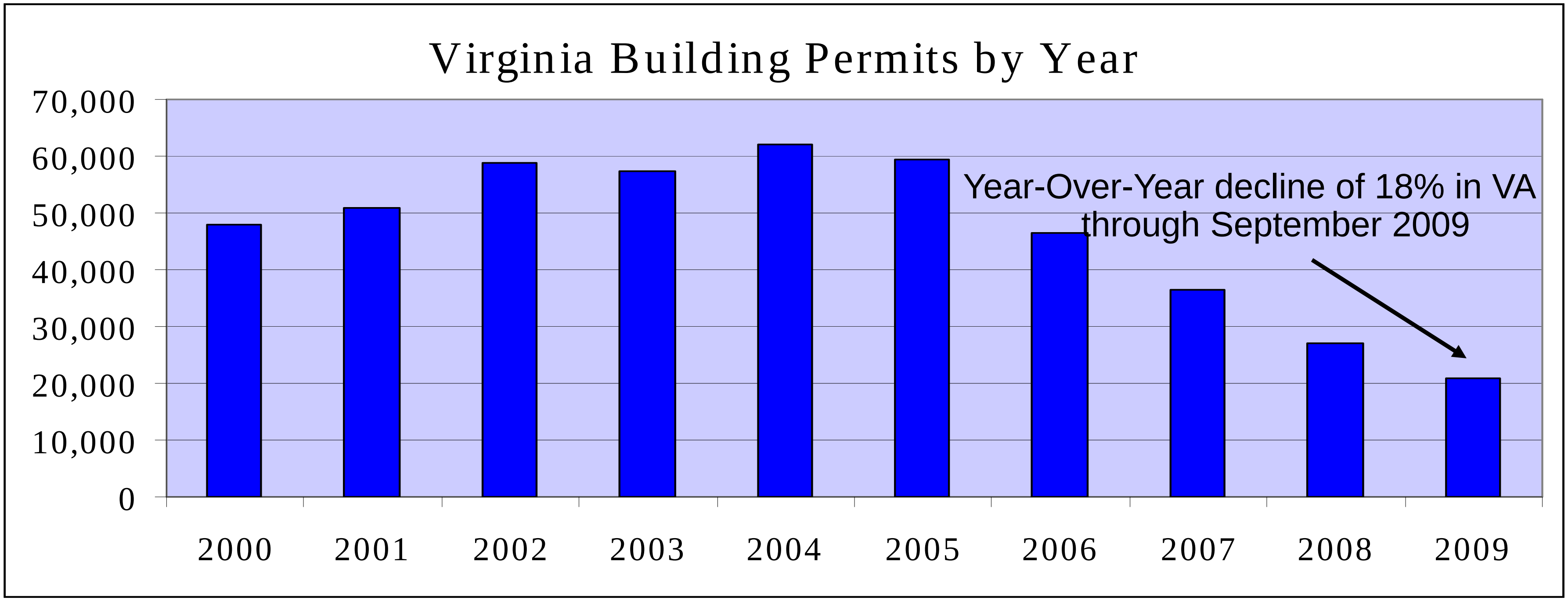
Key Housing Indicators Improving Nationally



*Millions, SA; **Single-Family Homes for sale divided by monthly selling rate

Housing Starts

- 2008 was the first year since World War II that new housing starts fell below 1.0 million nationally
  - Nationally, new home starts exceeded 2.1 million in 2005, fell to 1.3 million in 2007 and dropped to 900,000 in 2008
  - Expected to drop to 564,000 in 2009 before increasing to about 715,000 in 2010
  - New home starts expected to increase to 1.1 million in 2011 – levels about half that seen during the housing boom
- In Virginia, new permits are more than 60% below peak levels



Source: US Census Bureau October 20, 2009 Release on September construction

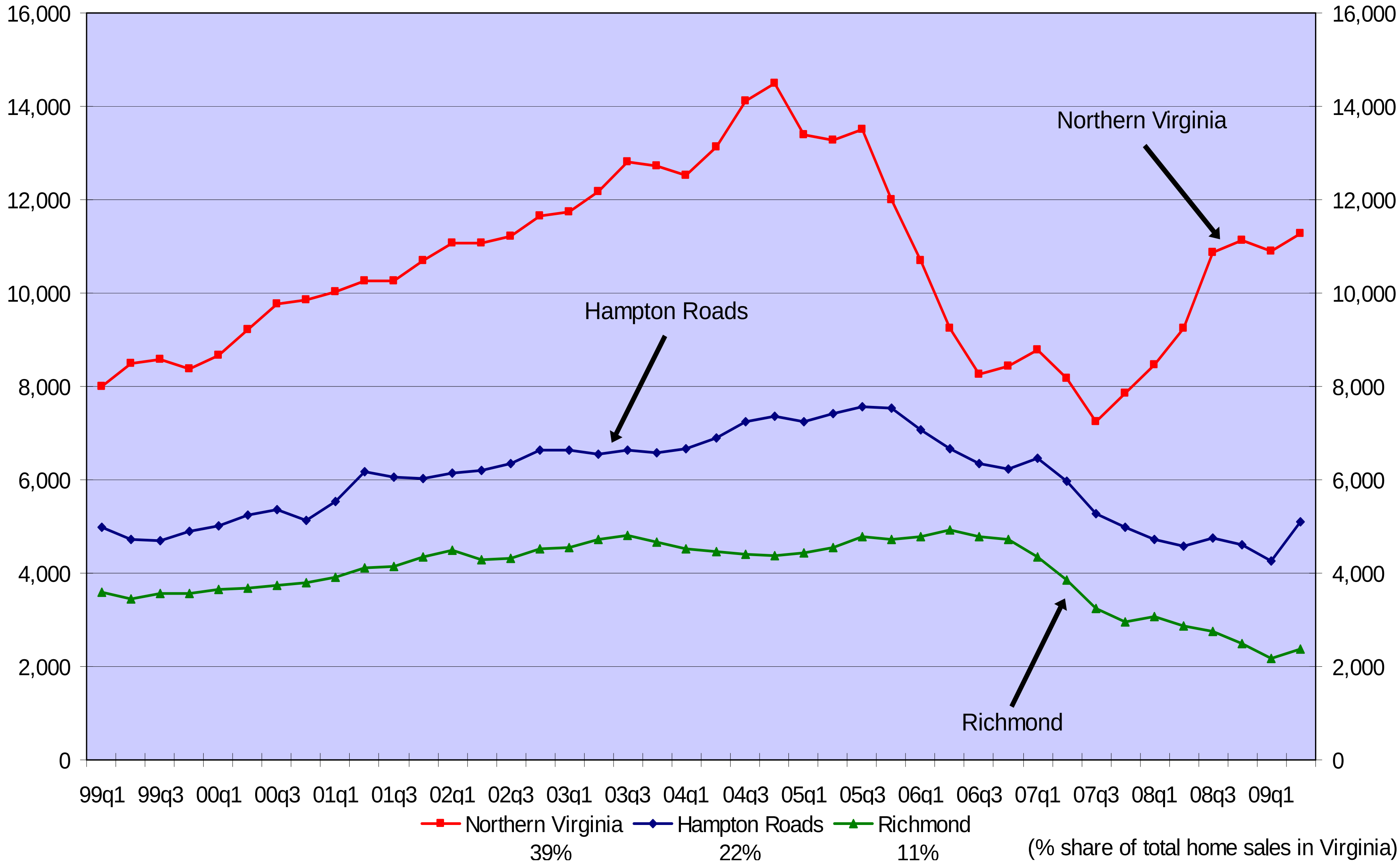
Virginia Sales Volumes

- After peaking in the third quarter of 2005, home sales volumes in Virginia fell to levels not seen since pre-2000
  - In Northern Virginia they have now moved back up to 2002/3 levels
  - Recovery not yet seen in Richmond where volumes remain below 2000 levels
- On a statewide basis, seasonally adjusted quarterly sales volume is at about 26,000 units, 9% above year-ago levels but still about 1/3 below peak levels
- Sales decline started in Northern Virginia first and that's where we first saw improvement
  - Sales picked up in mid-2008 in Prince William County, where drastic price declines and high foreclosure rates fueled a surge in sales activity
  - Sales have increased throughout 2009 in the remainder of the NOVA region
  - In the greater DC region, inventories are down 40% over last year's levels, and the months of supply is at a level considered a stable market supply
- Sales volumes in Hampton Roads have improved on a year-over-year basis as well, but the trends have been inconsistent
- In Richmond sales are still lagging – down on a year-over-year basis – but months' supply is down to 9.8 months, showing improvement over last year's levels

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

Levels

Seasonally-adjusted 2-quarter moving average

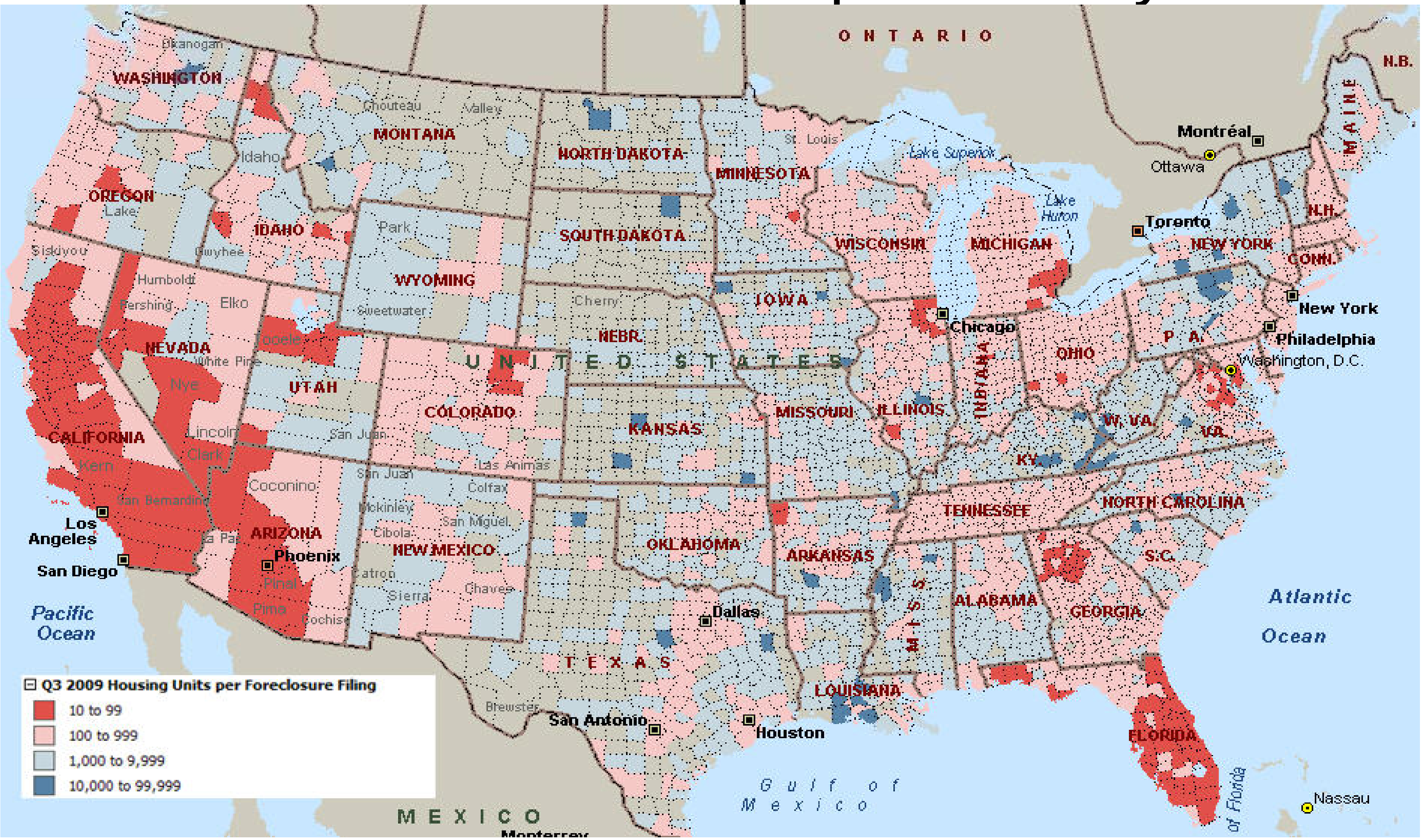


Source: Virginia Department of Taxation

Foreclosure Crisis Still Focused in a Few States

- The Mortgage Bankers Association reported that the foreclosure rate had reached 30-year highs nationally in September 2008 and foreclosures have continued to increase since that time
  - Rate has increased almost 10-fold since 2005 and delinquency rates are currently at the highest rate since MBA began tracking it in 1972
- RealtyTrac reported almost 1 million foreclosures in the 3rd quarter of 2009, an increase of almost 23% over the prior year
  - 1 in every 136 US housing units received a foreclosure filing over the 90-day period
- However, while foreclosures are increasing across the nation, California, Florida, Arizona, Nevada, Illinois and Michigan still account for 62% of all foreclosures
  - In Nevada, 1 in 23 homes received a foreclosure filing in the most recent quarter – nearly 6 times the national average

Where Foreclosures Cluster:
A few states are disproportionately hit



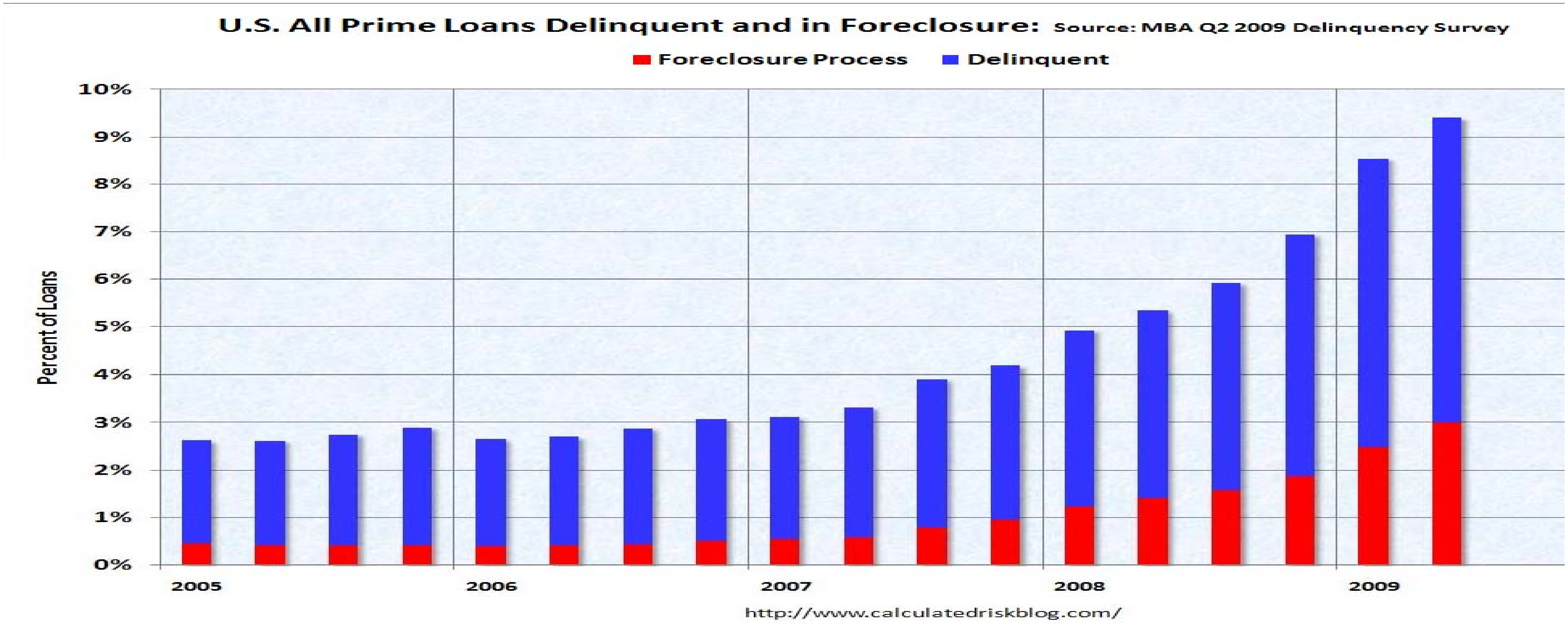
Source: RealtyTrac Report through Third Quarter 2009

Foreclosures in Virginia

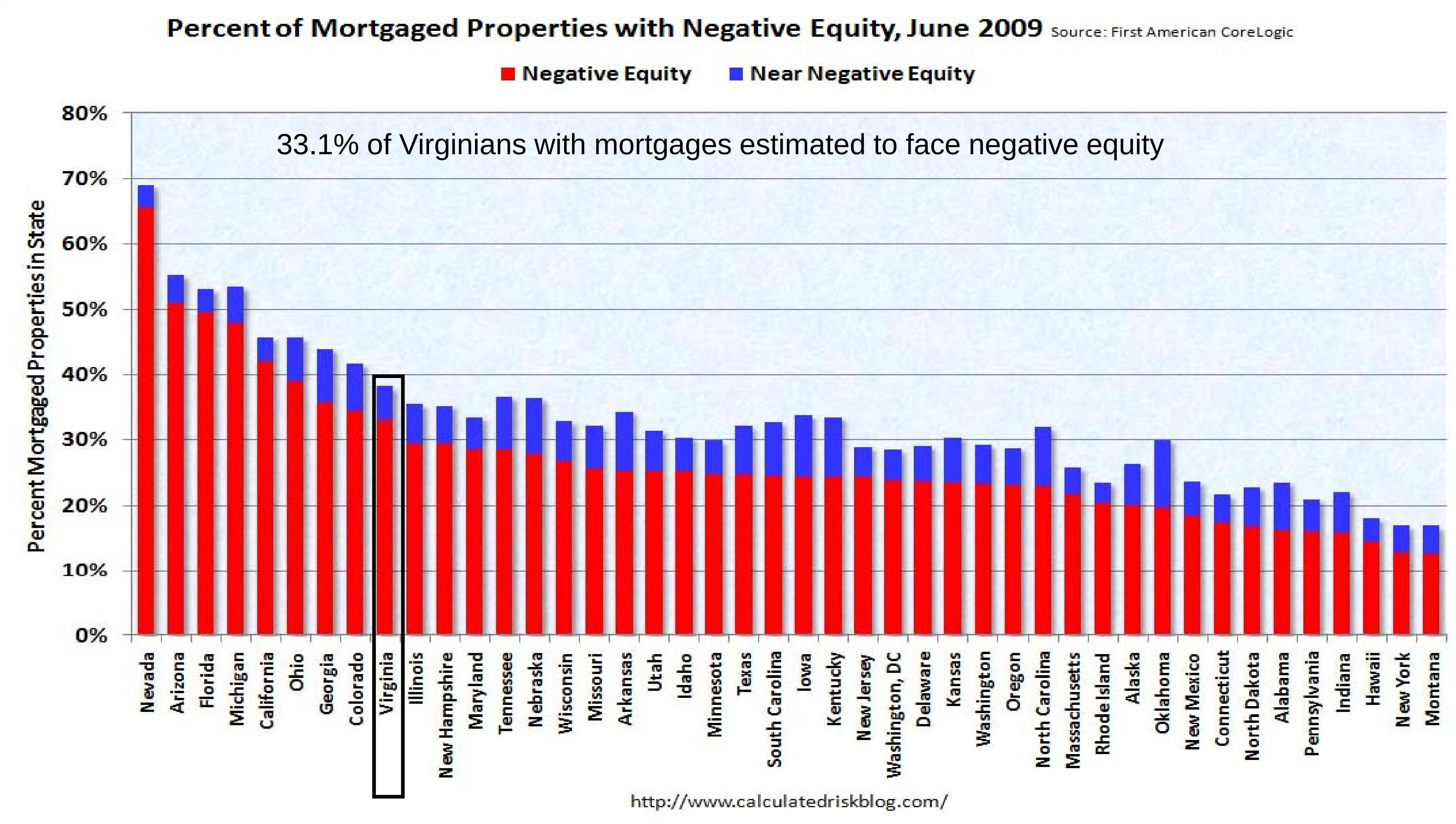
- Virginia, ranked 11th nationally in terms of foreclosure rates with 1 in 196 households receiving a foreclosure notice in the third quarter, quite similar to last year's comparative position
- Although VA is among the higher tier of states in terms of foreclosures, it is still below that national average of 1 in 136 households because of the concentration of foreclosures in just a few states
- In terms of recent trends, Virginia's foreclosure rate fell 4.7% in the most recent month, although on a year-over-year basis, foreclosures in the 3rd quarter were still 4% above the level reported in 2008
- Like the nation, foreclosures in Virginia continued to be concentrated in just a few jurisdictions
  - 52% of all foreclosures occurred in just 5 jurisdictions – Manassas, Prince William, Fairfax, Loudoun, Virginia Beach and Spotsylvania

If Foreclosure Rates Are Stabilizing, Why Are They a Continued Concern?

- In contrast to a year ago when foreclosures were largely attached to subprime, interest only and ARM loans, it has now expanded to the fixed rate prime loan market as well and these represent 1/3 of foreclosure starts; they were 1 in 5 a year ago
- Based of the trend in the number of homes in delinquency, the peak in foreclosures is not expected until the end of 2010



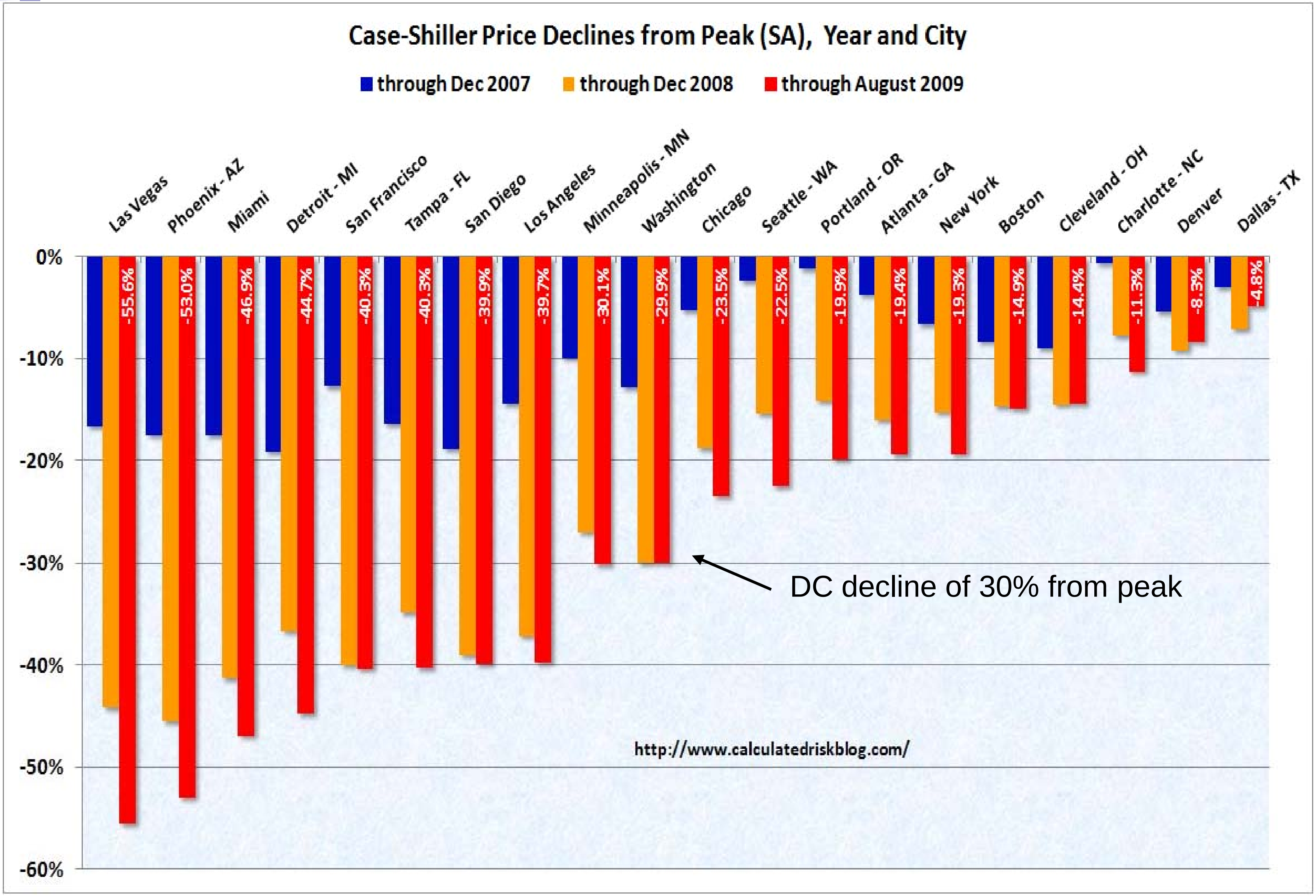
Growth of Underwater Homeowners Impacting Foreclosure Rates



Source: First American Core Logic

Home Prices

- Nationally, it is estimated that nominal home prices have declined 30% from their peak three years ago
  - Prices now down about 10% over year ago levels, but annual declines have slowed since February
- S&P Case Shiller index has shown new record declines for its 10 and 20-city indices
  - There are signs of a slowdown in the rate of decline, with certain cities now seeing price increases in 2009
- Since the December 2007, nominal prices have fallen by 30% in the Washington, DC metro area
  - This doesn’t capture total decline because DC went into housing slump earlier than most parts of nation
  - Days on market fell to 57 days in October, down from about 100 days at the height of the slump, but above the 30 day average during the boom
  - Inventory levels have fallen to stable levels, a necessary precursor to price appreciation as demand and supply become balanced

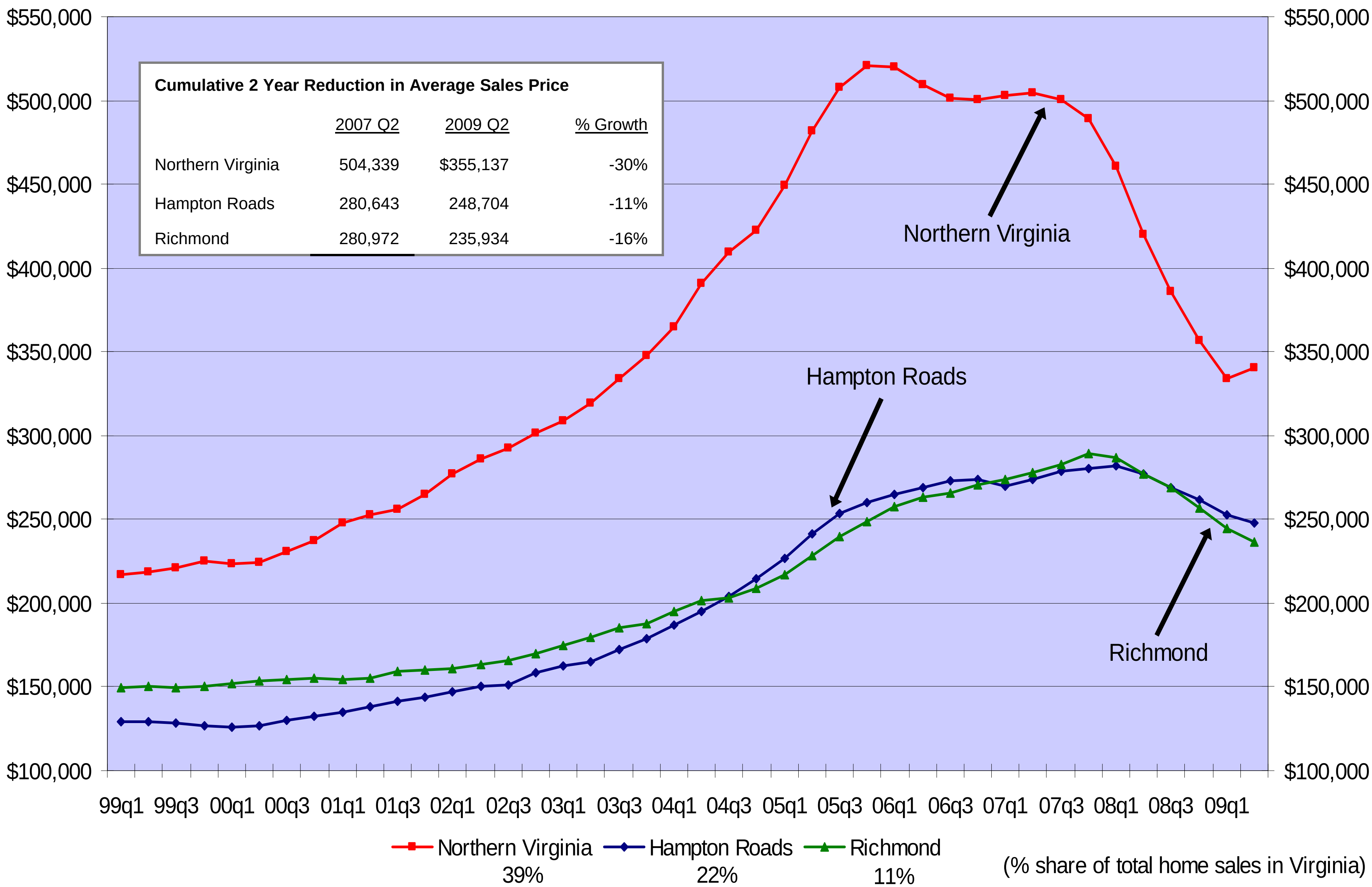


Case-Shiller Price Declines from Peak (SA), Year and City
through Dec 2007
through Dec 2008
through August 2009
Las Vegas
Phoenix - AZ
Miami
Detroit - MI
San Francisco
Tampa - FL
San Diego
Los Angeles
Minneapolis - MN
Washington
Chicago
Seattle - WA
Portland - OR
Atlanta - GA
New York
Boston
Cleveland - OH
Charlotte - NC
Denver
Dallas - TX
0%
-10%
-20%
-30%
-40%
-50%
-60%
-55.6%
-53.0%
-46.9%
-44.7%
-40.3%
-40.3%
-39.9%
-39.7%
-30.1%
-29.9%
-23.5%
-22.5%
-19.9%
-19.4%
-19.3%
-14.9%
-14.4%
-11.3%
-8.3%
-4.8%
DC decline of 30% from peak
http://www.calculatedriskblog.com/

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

Levels

Seasonally-adjusted 2-quarter moving average



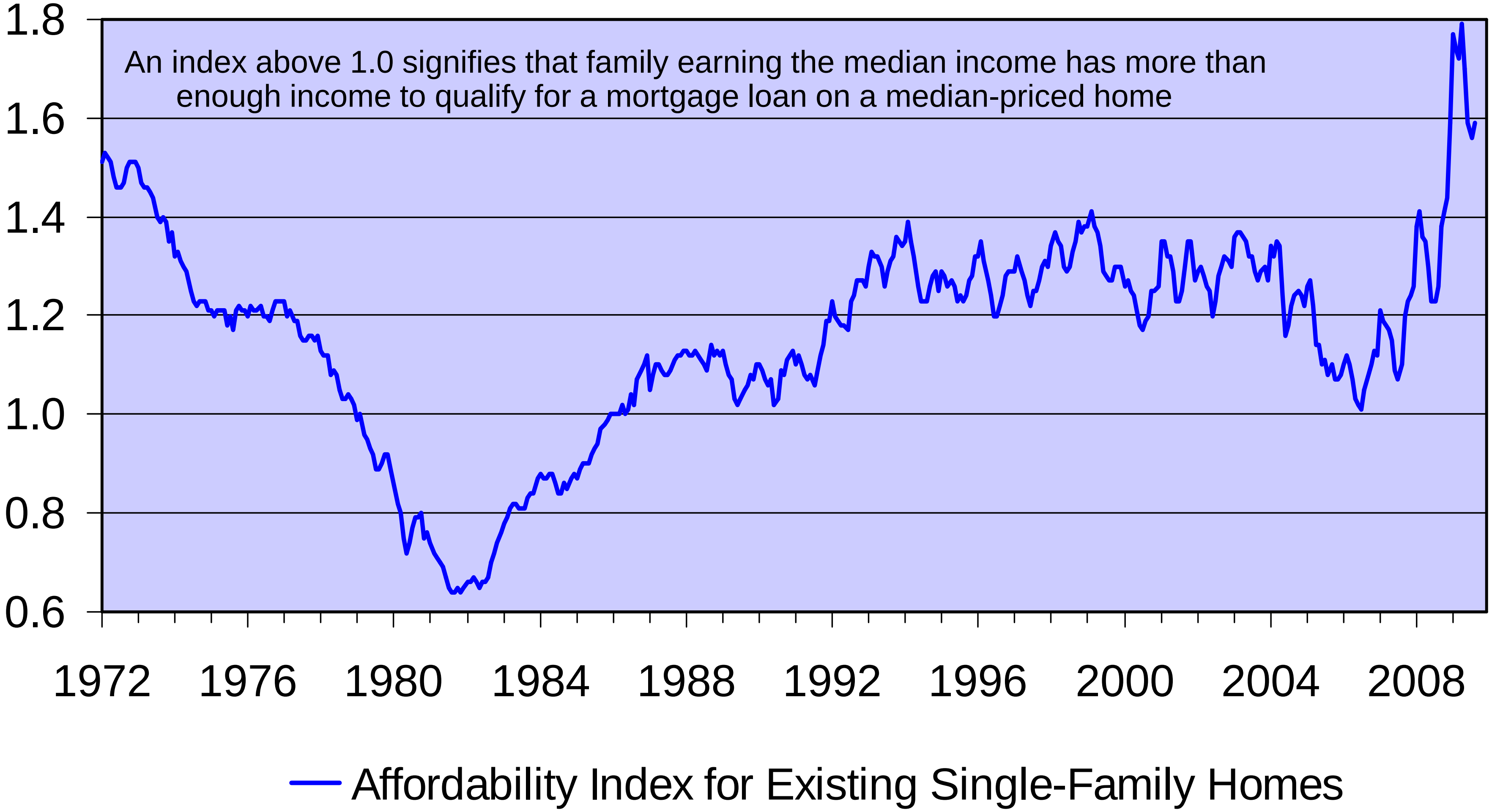
Cumulative 2 Year Reduction in Average Sales Price

	2007 Q2	2009 Q2	% Growth
Northern Virginia	504,339	$355,137	-30%
Hampton Roads	280,643	248,704	-11%
Richmond	280,972	235,934	-16%

(% share of total home sales in Virginia)

Nationally, Housing Affordability is at a Record High

A higher index means homes are more affordable.



Source: National Association of Realtors

Factors Influencing the Housing Recovery

Constraints:

- Homeowners “underwater” – negative amortization
- Impact of growing foreclosures on pricing – another dip?
- Growing unemployment

Positive Forces:

- Affordability has improved dramatically, especially in major markets
- Low level of housing starts and declining inventories point to long-term stabilization of supply
- Extension of the homebuyer tax credit – length of program, eligibility for “move-up” buyers, increase in income levels

General Fund Revenue Outlook

Fiscal Years 2010 - 2012

FY 2010: Expect Another Downward Revenue Adjustment

- FY 2009 general fund revenue collections fell short of the forecast by approximately $300 million
  - Governor ordered a reforecast of revenues which was presented on August 19th
- General fund revenue forecast for FY 2010 reduced by $1.2 billion
- The combined impact of the FY 2009 shortfall and the August reforecast creates a budgetary shortfall for FY 2010 of $1.35 billion
  - The $300 million FY 2009 shortfall plus the FY 2010 revenue revision were offset by a $150.0 million reserve the General Assembly set aside during the 2009 Session
- The fall reforecast process is underway, is the bleeding over?
  - GABE met on October 14
  - GACRE meeting next week – November 23

FY 2010: Where Do We Stand Year To Date?

- The August revised forecast assumes a revenue contraction of 1.6% in FY 2010 – the economic-based forecast is -2.6%

- Through October, revenue collections are 7.6% below FY 2009

- Expect to see additional downward adjustments to the FY 2010 revenue estimates when Governor introduces caboose budget in December. Of special concern are:
  - Withholding taxes, which make up 60% of GF revenues and are running far behind the forecast
  - Refunds, which are running 26% above FY 2009 levels
    - Year to date, we have paid out $45 million above the forecast

General Fund Revenue Forecast for Fiscal Year 2010

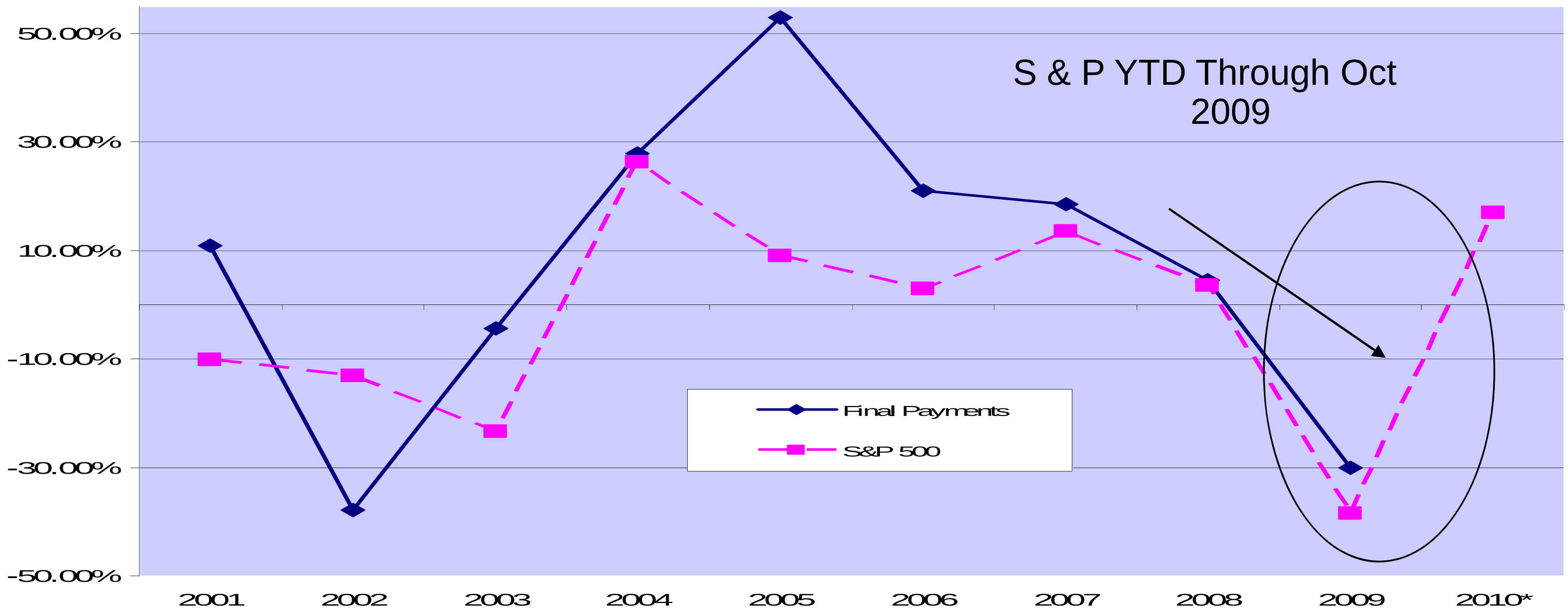
Major Source	Source as a % of Total Revenues	Chapter 781 Official Forecast	Dollar Reduction In Millions	August Forecast Revision	Y-T-D Performance
Withholding	**66.2**	**3.7%**	**-142.6**	**2.1%**	**-3.9%**
Nonwithholding	13.7	1.5%	-422.5	-16.8%	-24.8%
Refunds	**(13.8)**	**-9.2%**	**-158.2**	**-1.2%**	**25.9%**
Net Individual	66.1	5.8%	-723.3	-1.8%	-8.6%
Sales	20.5	8.7%	-265.4	-0.4%	-5.8%
Corporate	4.7	11.7%	-61.8	2.2%	-0.1%
Wills (Recordation)	2.0	-5.1%	-14.1	-9.6%	-9.2%
Insurance	1.8	11.0%	-27.6	0.2%	-
All Other Revenue	4.8	7.3%	-$90.4	-5.4%	-6.3%
Total GF Revenues	**100.0**	**6.6%**	**-$1,182.6**	**-1.6%**	**-7.6%**

FY 2010 Withholding Tax Collections

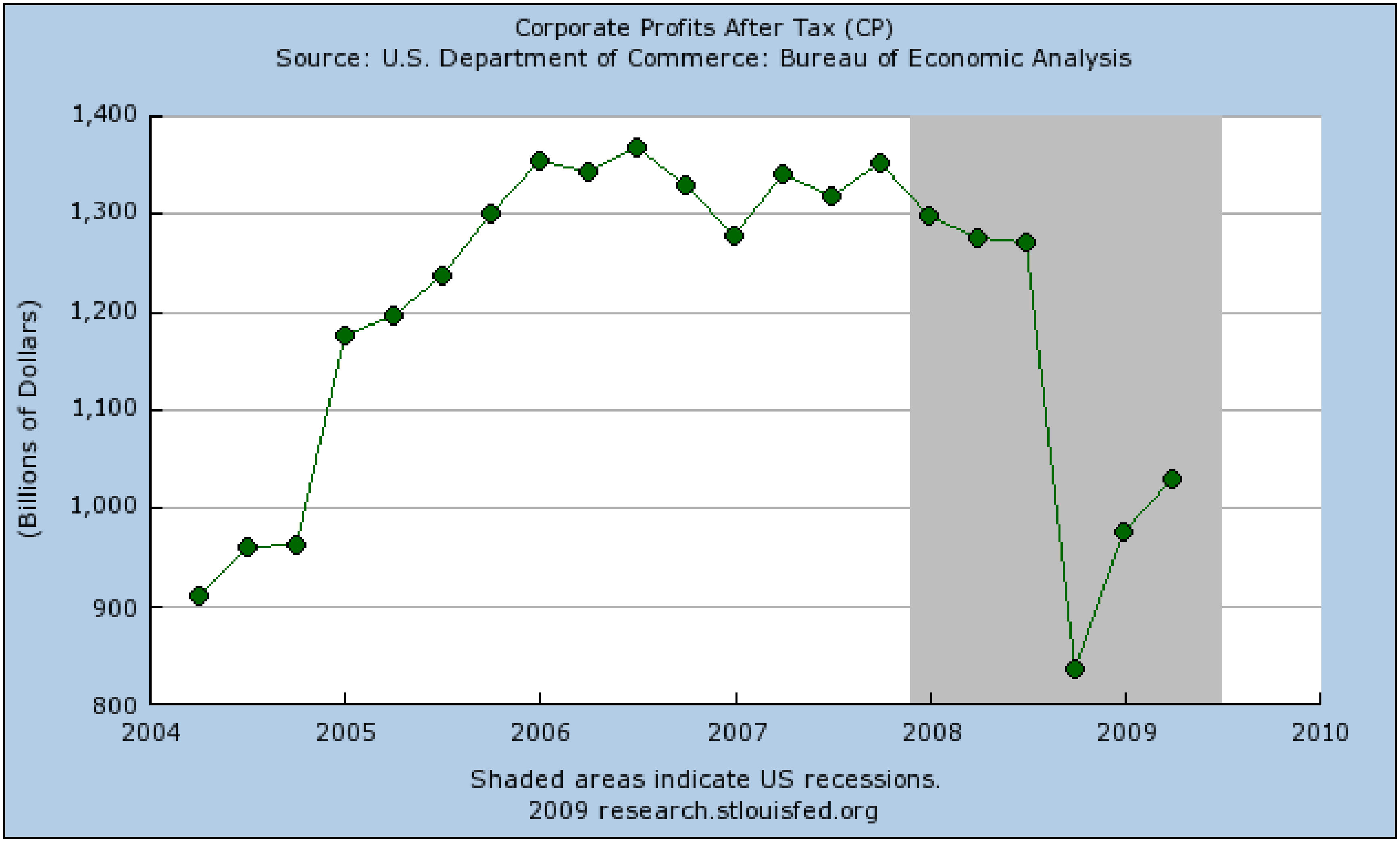
- Payroll Taxes: Forecast for year is +2.1%, actuals through October is -3.9%
- Over the last 15 years, Virginia has collected, on average, 31.3% of the year's withholding taxes in the first 4 months. Through October, 30.7% of the year's forecast has been collected
  - If this historic ratio is assumed, we would be about $170 million short on this source;
  - Using shorter (10-year) and longer (20-year) comparison periods (10 and 20 year), the shortfall would be between $125 to $245 million
  - Because withholding taxes account for 66% of total GF revenues (gross of refunds), even small swings have substantial revenue impacts

FY 2010 Nonwithholding Tax Collections

- Nonwithholding Taxes: Forecast for the year is -16.8%
  - Through October collections were at -24.8%
    - First estimated payment of year came in September – collections declined 27.5%
    - Forecast assumes 40% decline in final payments
  - Need to look at January estimated payments
  - Final payments, which account for 1/3 of revenue tend to track S&P 500 performance – through the end of October, the S&P was up 15.1%

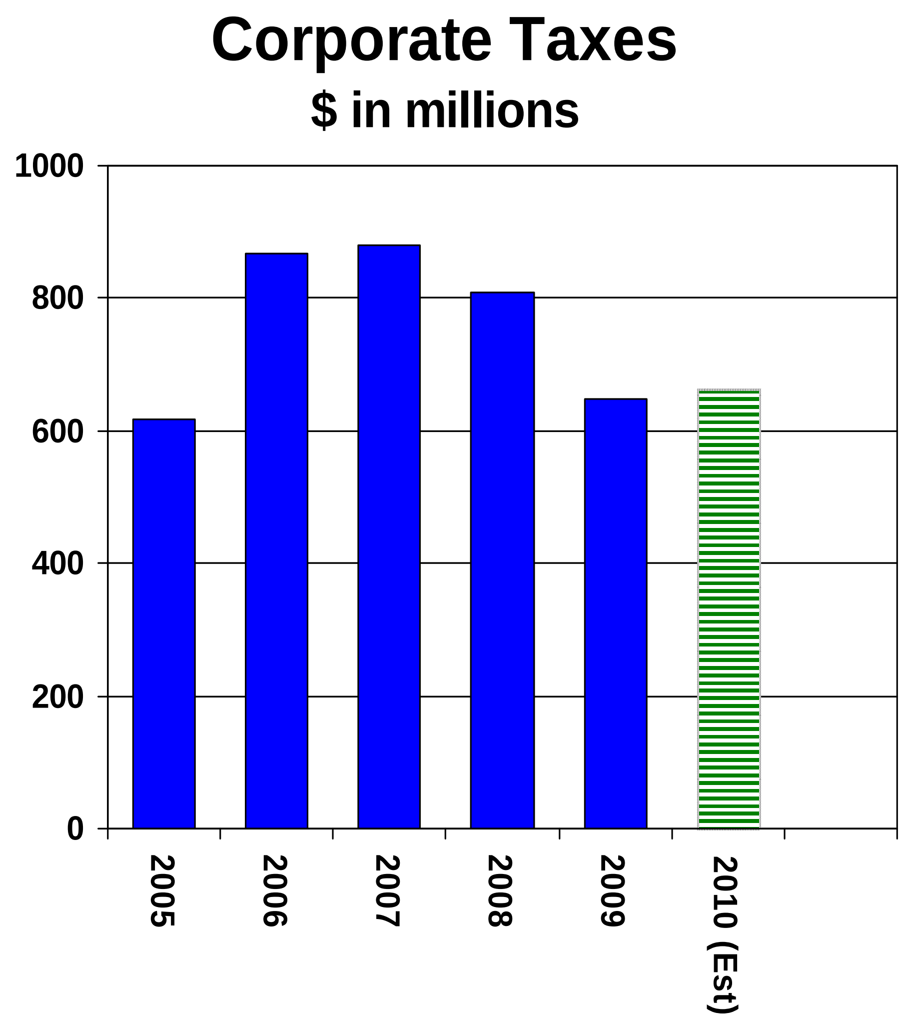


Corporate Quarterly Profits: While Down from a Year Ago Have Shown Improvement



FY 2010 Corporate Tax Collections

- U.S. corporate profits have seen improvement over the last 2 quarters, and based on preliminary 3rd quarter estimates, 80% of the S&P companies beat their earnings estimates
- FY 2010 forecast for corporate taxes is 2.2%,
  - Through October collections were at -0.1%
  - Ratio of 1st quarter collection to estimate is in line with historical ratios
- 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



FY 2010 Sales Tax Collections

- Sales Tax: revenue forecast for FY 2010 is -0.4%
- However, when adjusted for policy changes – the tax amnesty program and June sales tax remittance change – the economic forecast is -4.1%
  - Expect sales tax to appear below forecast until end of year because the sales tax remittance change generates revenue in the last month
  - In combination, adopted policy changes are expected to generate $96 million in additional sales taxes
- Through October, sales tax collections were 5.8% below FY 2009 levels, with monthly collections at -5.4%
- Each 1% change in the sales tax forecast results in a revenue swing of just under $30 million

Likely December Forecast Adjustment for FY 2010

- Looking at year-to-date performance on the major general fund revenue sources, one can predict that additional forecast reductions for FY 2010 are likely to be in the range of $250 – $300 million based on year-to-date performance, and historic ratios for certain revenue sources
  - These adjustments will be included in caboose bill in December

- Any adjustments in FY 2010 impact the forecast for the next biennium – even if the same growth rates are applied, a lower base means a similar amount is lost in each of the out-years

Historic Revenue Growth Trends Not Expected

- Historically, how have general fund revenues grown?

	Average Annual Growth
Last 5 years (FY03 to FY08)	+7.6%
Last 10 years (FY98 to FY08)	+6.0%
Last 15 years (FY93 to FY08)	+6.5%
Last 20 years (FY88 to FY08)	+5.9%
Last 25 years (FY83 to FY08)	+6.9%
Last 30 years (FY78 to FY08)	+7.3%
Last 35 years (FY73 to FY08)	+8.0%
Last 40 years (FY68 to FY08)	+7.8%

- The current official long-term forecast of general fund revenues (released August 2009) call for slower growth next biennia

Looking to the FY 2010-2012 Biennium

- **Expect:**
  - Slower revenue growth
    - FY 2011: 3.8%
    - FY 2012: 5.3%
  - Growing spending needs as the result of recessionary pressures, rising costs, and unmet needs, as well as
  - The end of enhanced federal aid as the stimulus package begins to terminate in FY 2011
- **Means that:**
  - Budget reductions in many areas will be needed to maintain fiscal balance
  - Significant budget pressures will continue in the next biennium
    - Budget for 2010-12 will require level funding of many major programs
    - Objective will be to “manage” all aspects of the budget

Balancing Virginia's FY 2010 Budget and Building Next Biennial Budget on Below Trend Growth

Actions Proposed By Governor To Close The Budget Gap in FY 2010

- In September, Governor announced his plans to address the current year shortfall based on the August reforecast

- Major one-time actions used to close the current year shortfall include:
  - Withdrawal of $283.0 million from the Revenue Stabilization Fund
  - $134.0 million by deferring 4th quarter payments to the VRS
  - $97 million in additional savings from enhanced Medicaid match
  - $68.9 million in additional stimulus funds to backfill K-12 reductions
  - $105.4 million from capturing a variety of unexpended GF and NGF balances

The Objective For FY 2010 Should Be to Structurally Balance the Budget

- Because only about $750 million of the savings strategies announced by the Governor in September will be carried into new biennium we face a gap in the base budget

- Reliance on one-time actions creates a structural imbalance in the 2010-12 budget
  - Out-year forecast assumes revenue growth of less than 4% in the first year and 5.3% in the second year
  - Every $145.0 million in one-time actions in FY 2010 requires 1 percent of revenue growth in FY 2011

- In managing the 1991 recession, one-time actions were used for several years, which prolonged the structural imbalance in the budget until 1996

Budget Outlook for FY 2010-12 Biennium

- Base budget equals FY 2010 adjusted to reflect:
  - Removal of one-time spending
  - Annualization of partial-year adjustments – spending requirements and budgetary savings identified
  - Carry-forward of FY 2010 savings identified by Governor in September
  - Adjustments to reflect phase-out of ARRA funding
- What are required adjustments for known budget drivers?
  - Mandatory and statutory only
  - How does it all fit?

Adjusted Base Budget for FY 2011/12

(GF Dollars in Millions)

	FY 2011	FY 2012
Chapter 781 (FY 2010 Base)	$15,844.0	$15,844.0
Remove Capital Outlay	($0.8)	($0.8)
On-going Sept 2009 Budget Reductions *	($618.6)	($618.6)
Annualize Partially Funded Costs (Jail staffing, rent costs)	$6.3	$6.3
Remove One-Time Spending & Technical Adj.	($6.2)	($8.3)
Prior Commitments (includes Rolls Royce, DOC Equipment, Land Conservation Fund, Economic Development Incentives)	$33.1	$27.9
HAC Estimated Base Budget	$15,257.8	$15,250.5

* Revised December 2, 2009 to reflect the exclusion of $97.0 million in Medicaid and $30.0 million in the Literary Fund from ongoing savings

2010-12 Budget Drivers

Selected Mandatory/Statutory Spending

GF $ in Millions	FY 2011	FY 2012	Total
Medicaid - Backfill ARRA	372.0	803.9	1,175.9
Medicaid Utilization and Inflation (Preliminary)	239.5	463.6	703.1
Capital Outlay – Treasury Board Debt Service	68.9	114.8	183.7
K-12 Prelim Re-benchmarking (SOQ, Incentive & Categorical)	51.8	92.8	144.6
State Employee Health Insurance Rate Adjustments	46.4	115.0	161.4
VRS Rates State Employees (cost depends on actuarial assumptions used to determine rates)	7.7	7.7	15.4
VRS Rates (Teachers) (cost depends on actuarial assumptions used to determine rates)	38.0	38.0	76.0
Sheriffs – New Jails and Byrne Grant Backfill	17.3	22.3	39.6
Direct Inmate Health Care	12.5	15.6	28.1
Loss of DOC Out-of-State Inmate Revenue	7.2	7.2	14.4
Foster Care & Adoption Asst and Child Support Backfill ARRA	8.3	13.2	21.5
Criminal Fund	2.0	4.0	6.0
OCME Melendez-Diaz Ruling Fund	1.9	1.9	3.8
Comprehensive Services Act	TBD	TBD	TBD
Children's Health Insurance (FAMIS / SCHIP)	TBD	TBD	TBD
Involuntary Mental Commitment Fund	TBD	TBD	TBD
TOTAL – Known Budget Drivers	**$873.5**	**$1,700.0**	**$2,573.5**

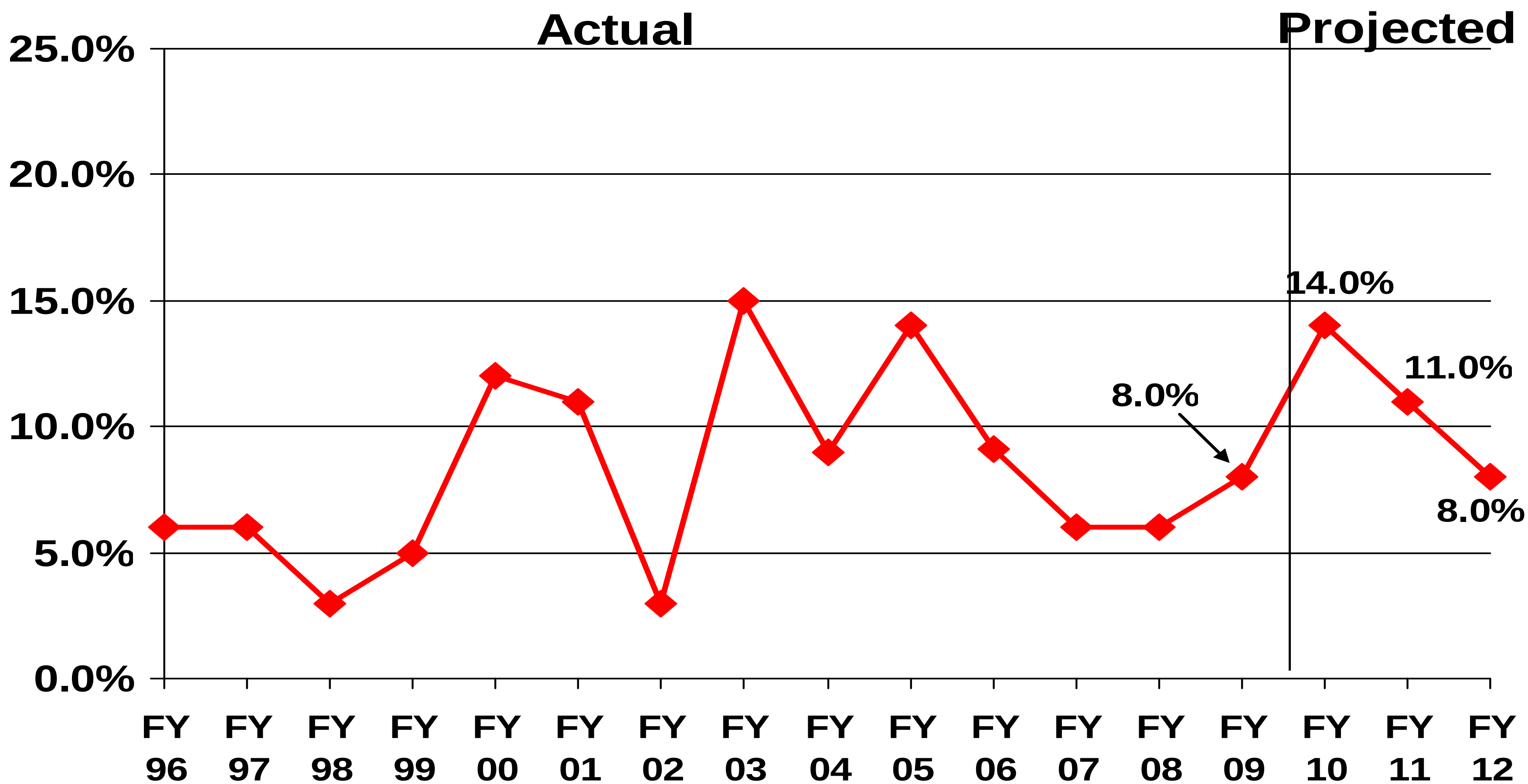
Virginia Medicaid Program

- Program costs are shared by the state and federal government
- Federal share is historically 50%
- ARRA legislation provided a temporary increase in the federal medical assistance percentage (FMAP) for 9 quarters beginning October 1, 2008 through December 31, 2010
  - 6.2% increase in state's FMAP
  - Additional 3-tiered percentage increase based on increase in state's unemployment
- Blended FMAP for FY 2009 was 57.29%
- FMAP for FY 2010 is 61.59%
- FMAP for FY 2011 is 61.59% for first 2 quarters and 50% for last 2 quarters

Medicaid Utilization & Inflation

(all funds)

- Average annual expenditure growth: 8.1% historical, 11% projected



Source: DPB and DMAS Consensus Forecast

Factors Affecting Medicaid Spending Growth

- Increased payments to providers
  - Rebasing and inflation of nursing home and hospital payments required by regulation
  - Increase in capitation rates for managed care organizations recommended by actuary
    - 12% in FY 2011 and 8% in FY 2012
  - 3% increase in personal care rates adopted by 2009 General Assembly
- Added mental retardation waiver slots
  - Annualized cost for 200 slots restored by General Assembly in spring of FY 2009
  - Annualized cost of 100 new slots to be implemented Jan. 1, 2010
- Increased enrollment for mandated groups
  - Substantial growth in the number of non-disabled adults and children
    - 2% annual growth in FY 2008
    - 8% annual growth in FY 2009
    - 13.2% projected in FY 2010
  - Slight growth in aged blind and disabled
    - 2% in FY 2008
    - 2.4% in FY 2009
    - 3.5% projected in FY 2010
- FY 2010 growth rate artificially high because there was one less Medicaid provider payment cycle in FY 2009

Preliminary Medicaid Forecast GF Need

(GF $ in millions)

DMAS Programs	FY 2010	FY 2011	FY 2012
Medicaid Enrollment & Utilization	$49.7	$170.0	$348.4
Backfill Federal Stimulus Funds		$330.1	$734.4
Provider Rebasing & Inflation Per Regs.		$57.4	$88.0
Backfill Federal Stimulus Attributable to Funding for Rebasing & Inflation		$34.6	$53.1
Additional MR/DD Waiver Slots (HB 2644 / SB 1501)		$12.1	$27.2
Backfill Federal Stimulus Attributable to funding for New MR/DD Waiver Slots		$7.3	$16.4
Total Medicaid Forecast GF Need	**$49.7**	**$611.5**	**$1,267.5**
Note: The GF need for Medicaid Utilization & Inflation will be adjusted when the projected revenues for the Virginia Health Care Fund (VHCF) are finalized. Savings from the September budget reductions are not reflected in Medicaid forecast. Separate budget actions will reflect September savings.			

2010-12 Biennium Revenue Outlook

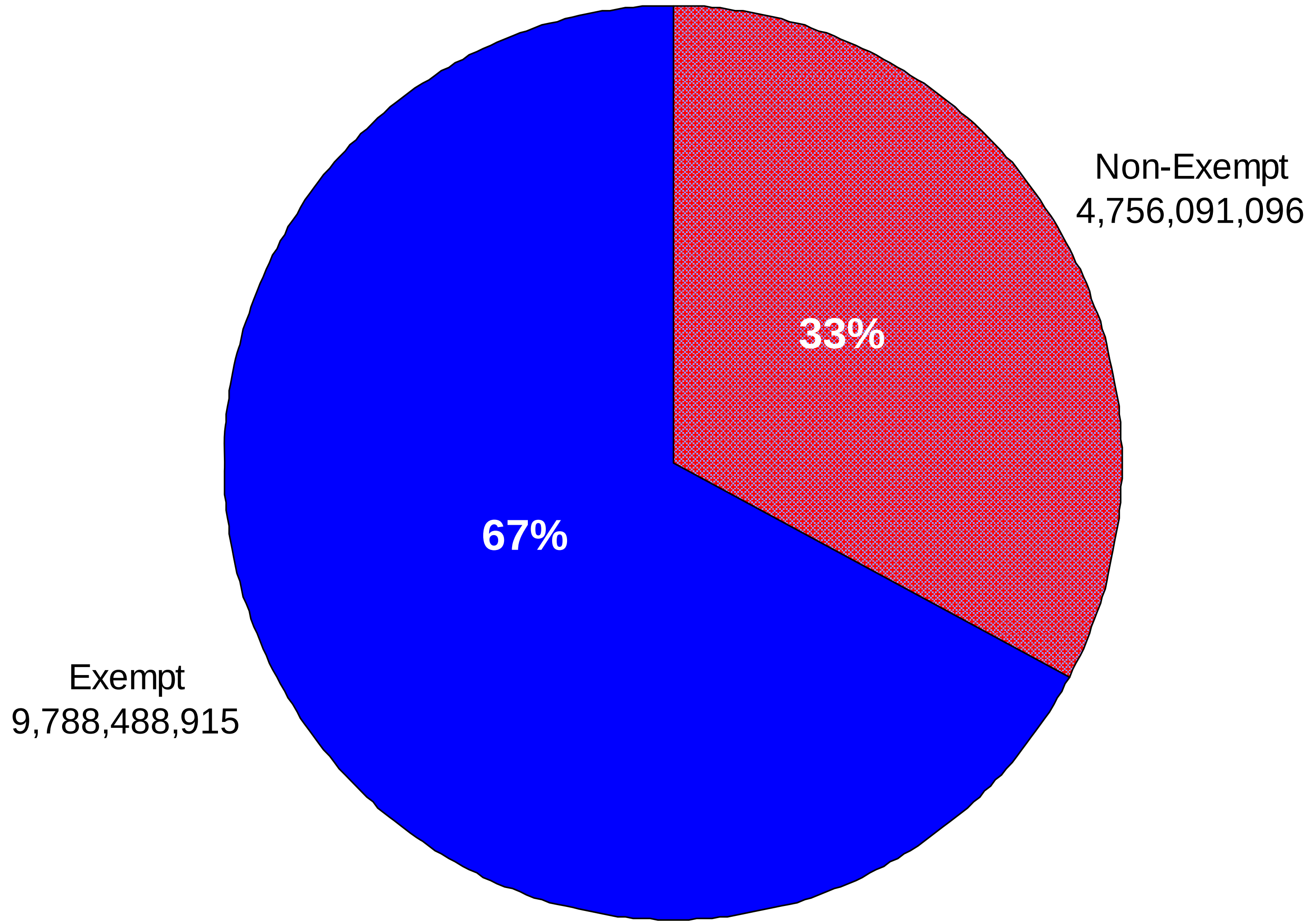
$'s in millions	FY 2011	FY 2012	Biennium
GF Revenue (August forecast) - Incl. Transfers	$14,946.5	$15,768.2	$30,674.7
HAC Revenue Adjustment	($250.0 - 300.0)	($250.0 - 300.0)	($500.0 - 600.0)
Resources Available	$14,646.5 -14,696.5	$15,488.2 -15,518.2	$30,074.7 - 30,174.7
HAC Base Budget *	$15,257.8	$15,250.5	$30,508.3
Net Resources For Budget Drivers	($434.3 - 484.3)	$344.7 - 394.7	($79.6 -179.6)
Mandatory/Statutory Spending Drivers	$873.5	$1,700.0	$2,573.5
Potential Budget Gap	($1,434.8 - 1,484.8)	($1,432.3 - 1,482.3)	($2,867.1 - 2, 967.1)

* Revised December 2, 2009 to reflect the exclusion of $97.0 million in Medicaid and $30.0 million in the Literary Fund from ongoing savings

Budget Strategies

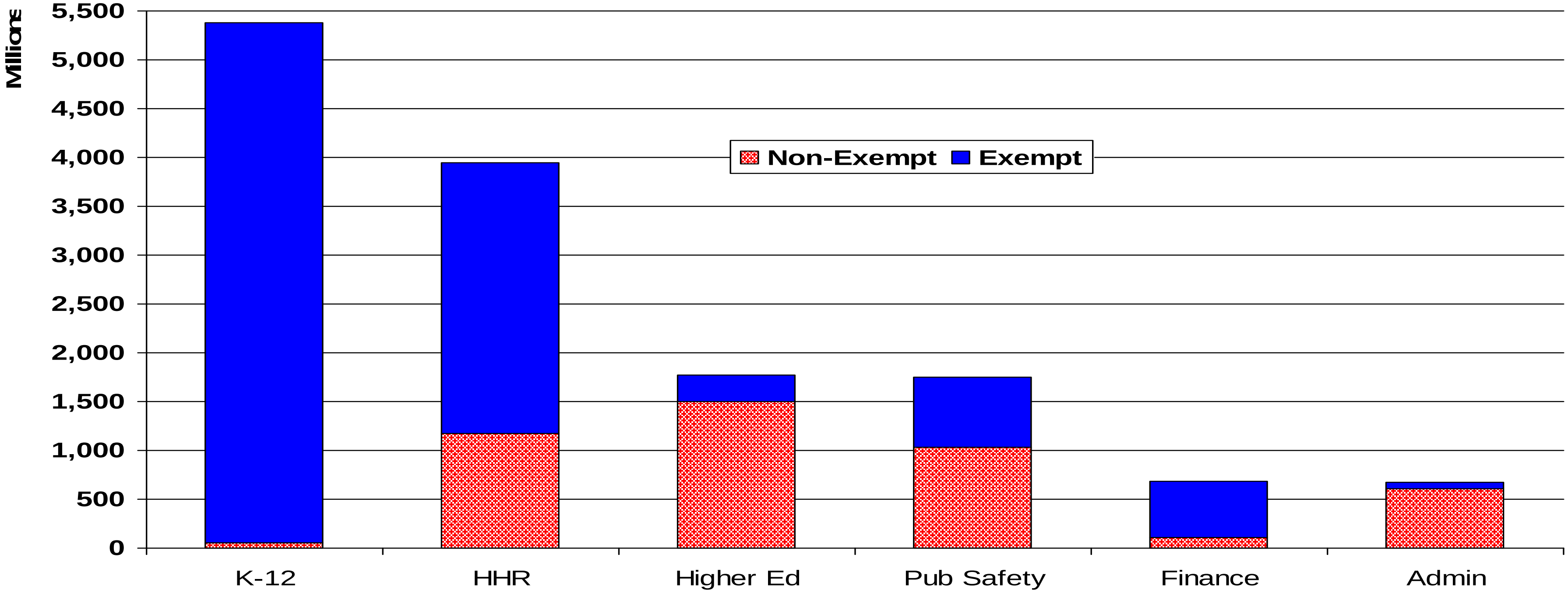
- Reduce or delay rebasing, rebenchmarking and inflation of selected budget drivers
- Eliminate new operating initiatives implemented since 2008 Session
- Prospective changes to VRS in order to reduce future costs and phase-in unfunded liability
- Review program eligibility requirements and optional services
- $330 million in unallocated ARRA funding for education (K-12/higher ed) will be available in FY 2011
- Equalize across-the board reductions on non-exempt areas
  - Bring all state agencies to 10% reduction level
  - Bring all state agencies to 15% reduction level
  - Each additional 1% on reduced base generates $40 million

Exempt vs. Non-Exempt Total Budget



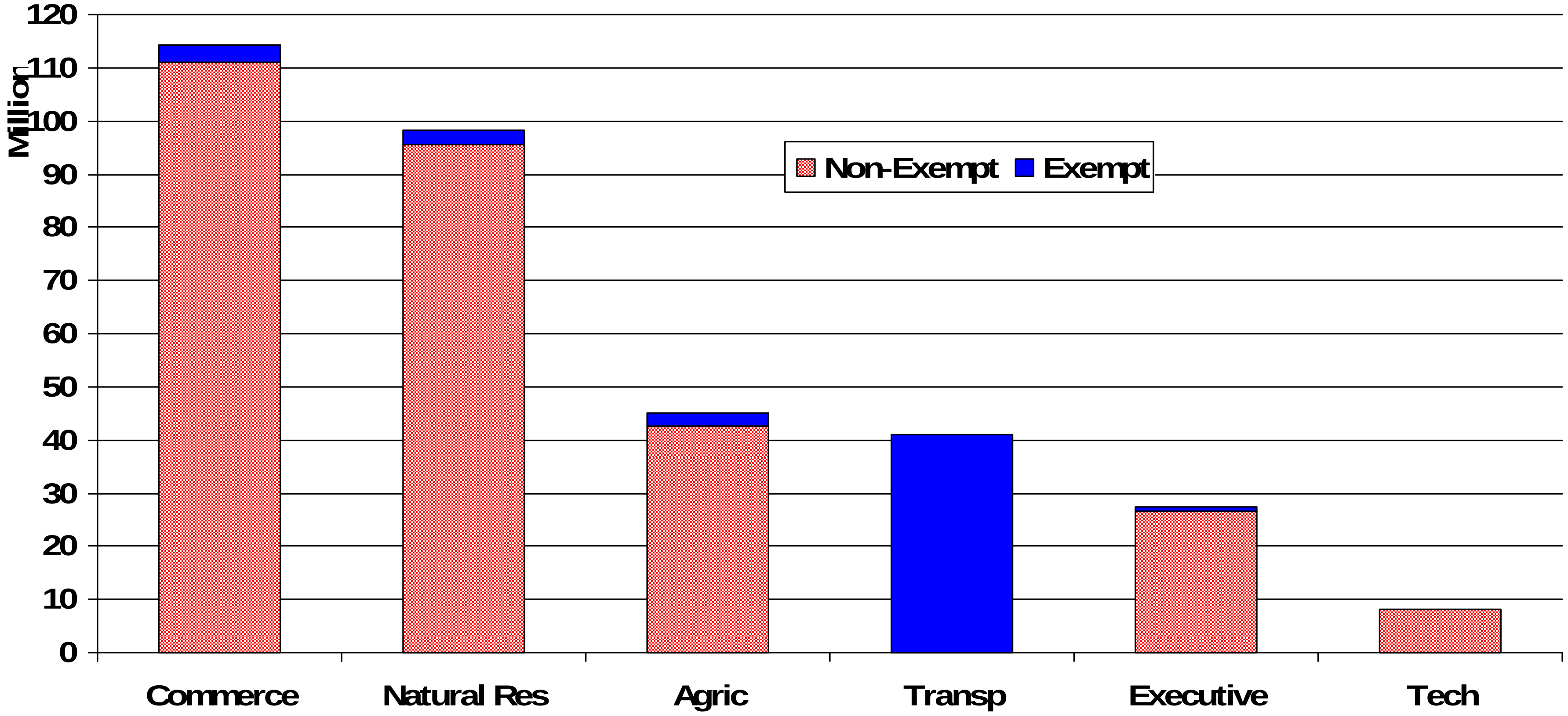
Exempt vs. Non-Exempt Budget

- What did the Governor consider exempt?
  - Aid to individuals
  - Direct Aid to K-12
  - Financial Aid
  - Debt Service
  - Payments to Localities
  - Adult and Juvenile Corrections Operations



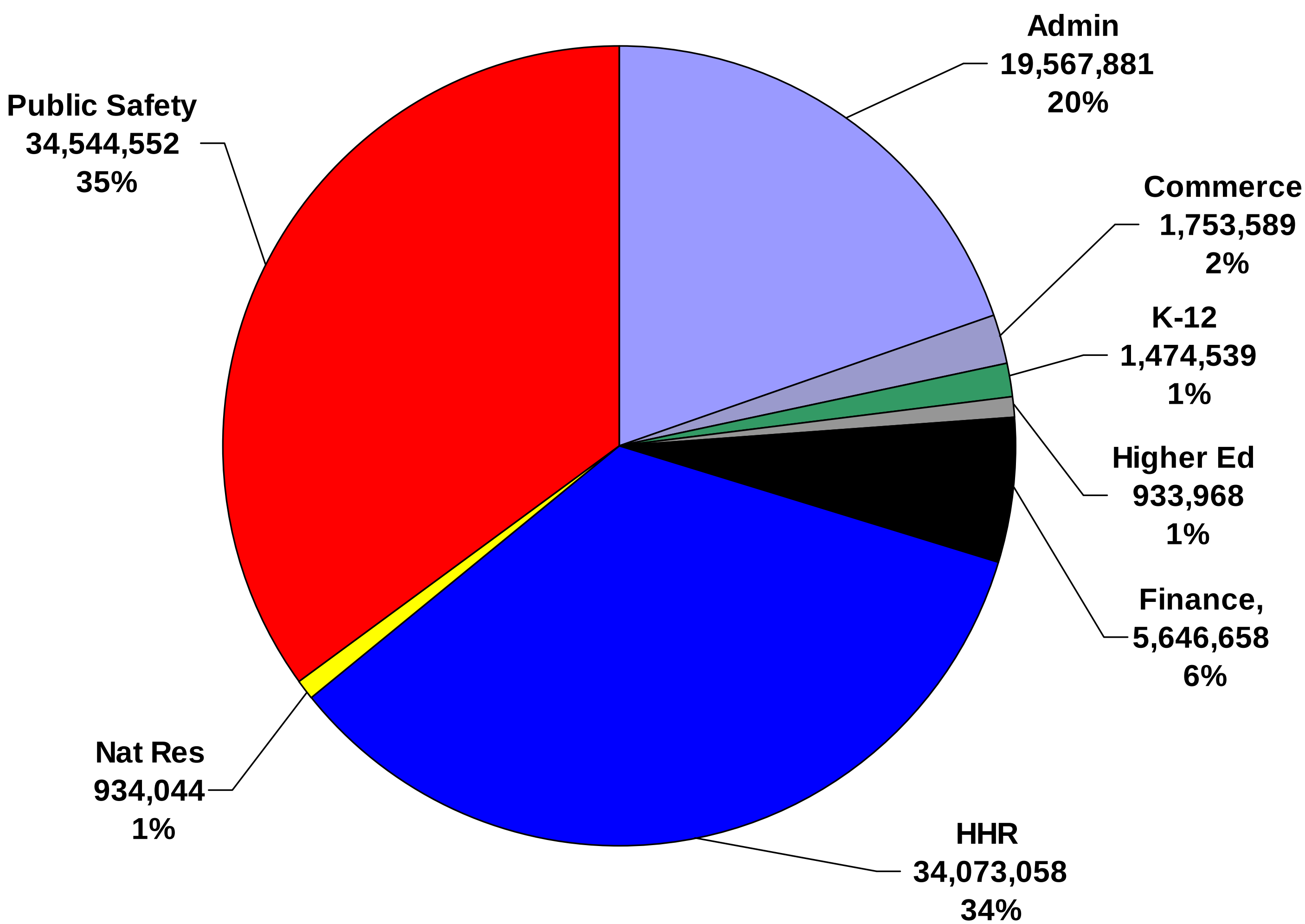
Exempt vs. Non-Exempt Budget

- Transportation exemption includes the $40 million of recordation tax going to Route 58 debt service & VPA payments in lieu of taxes



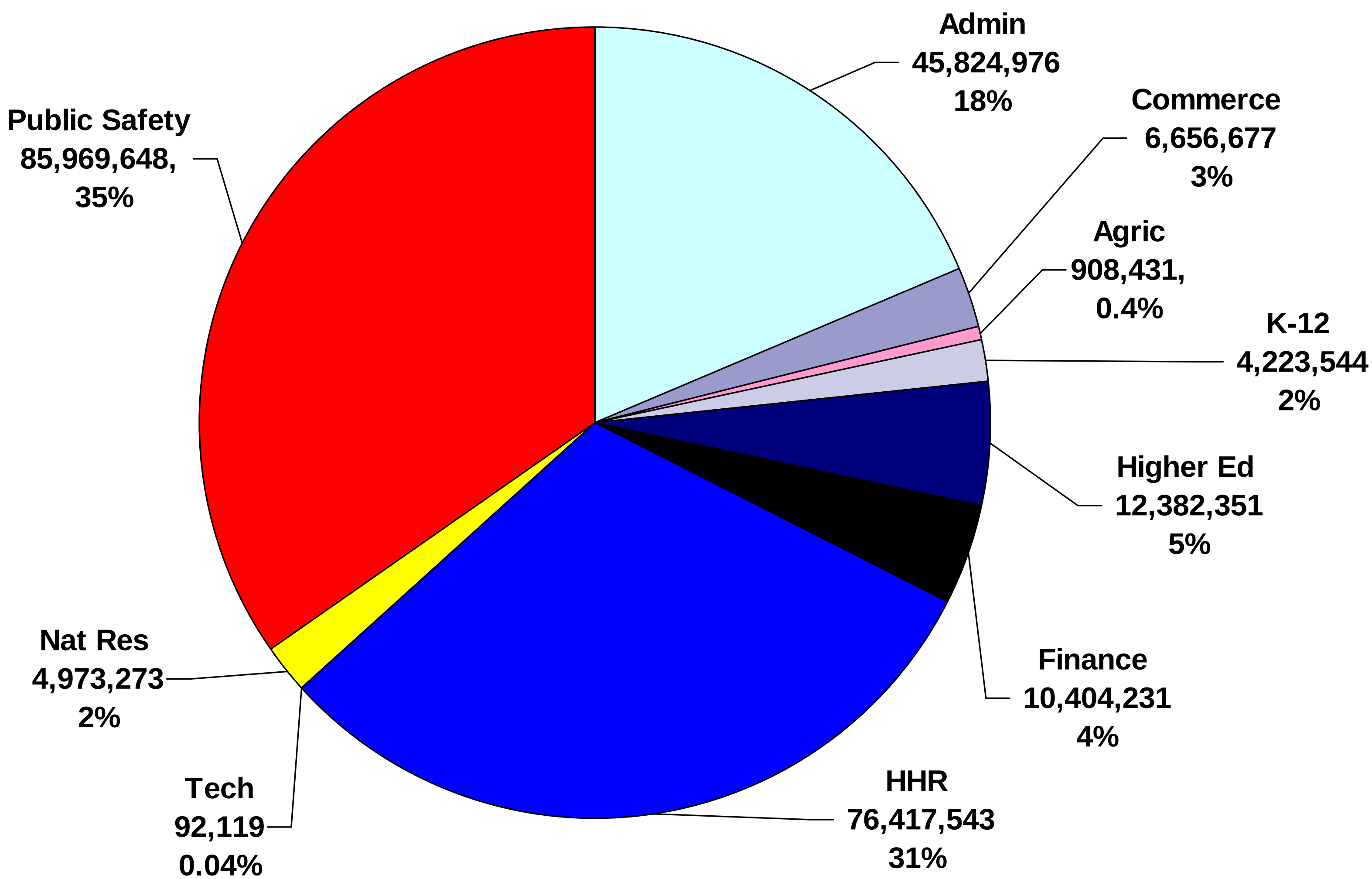
Budget Reduction Options

Bring All Agencies to 10%
$98.9 million



Budget Reduction Options

Bring All Agencies to 15%
$247.9 million



Equalize Across-the-Board Reductions

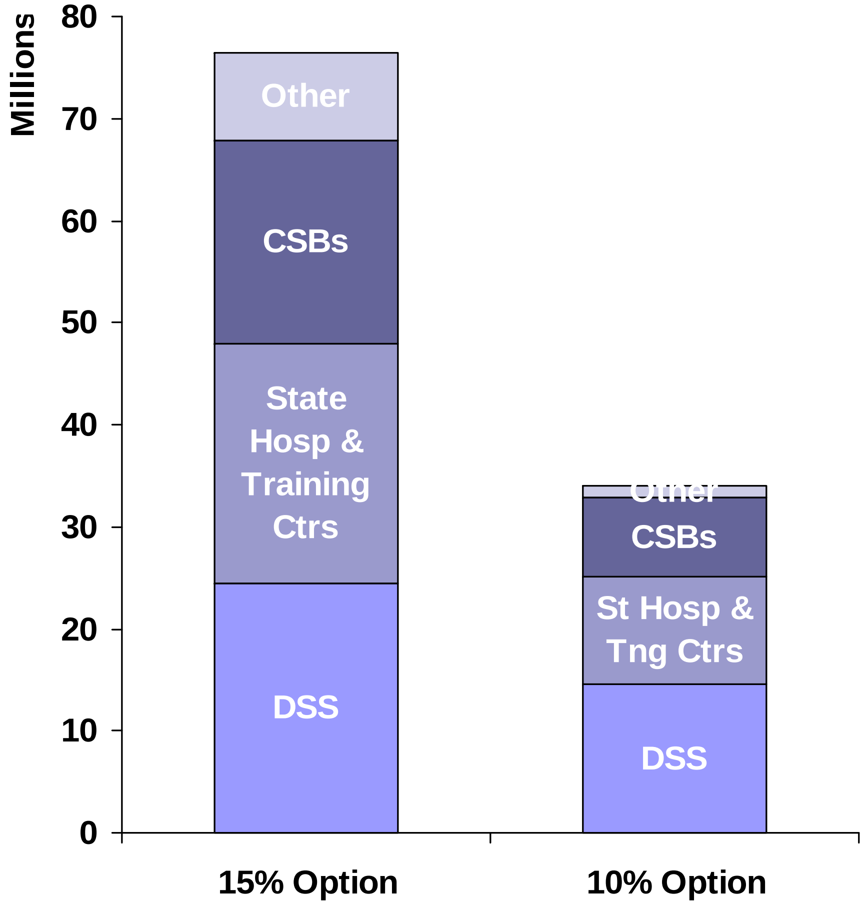
Impact on HHR

<u>Impact of 10% Option: $34.1 million</u>

- Reduce local services to 2,917 mentally disabled clients
- Reduces 256 direct care staff at mental health hospitals
- Reduces 50 direct and support staff at training centers
- Reduces funding for local DSS staffing and operations

<u>Impact of 15% Option: $76.4 million</u>

- Reduce local services to 5,834 mentally disabled clients
- Reduces 426 direct care staff at mental health hospitals
- Closes one unit at the training centers
- Reduces funding for local DSS staffing and operations
- Eliminates in-home services for the low-income elderly



Equalize Across-the-Board Reductions

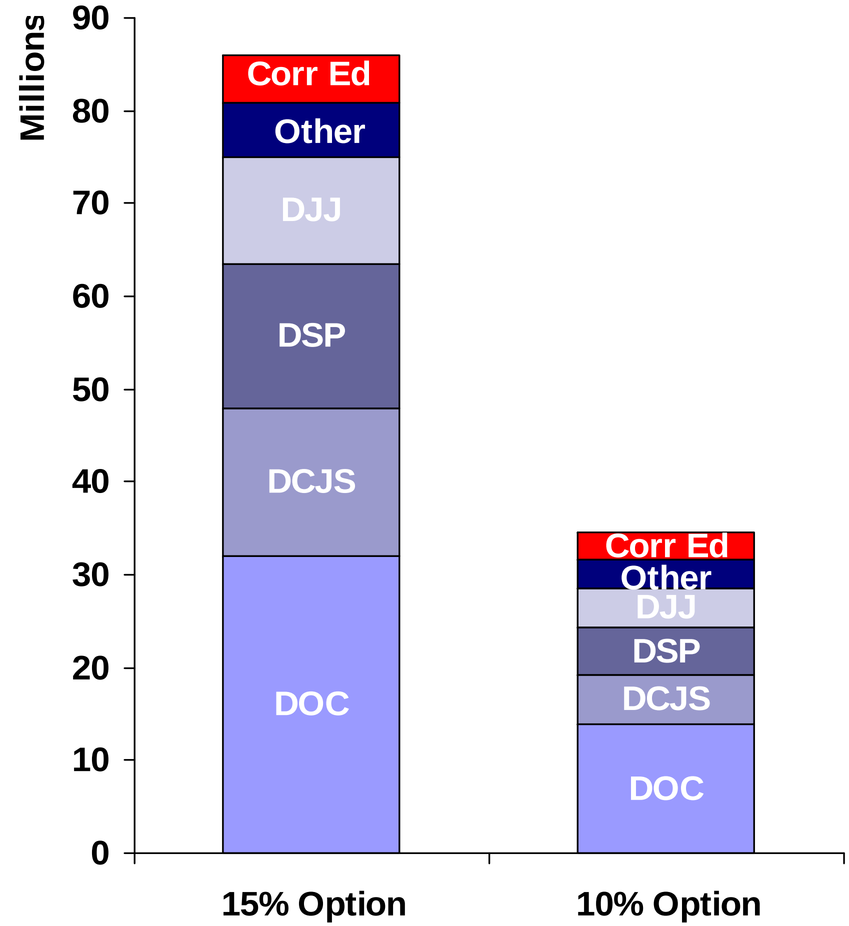
Impact on Public Safety

Impact of 10% Option: $34.5 million

- Maintain large vacancy rates and reduce equipment spending at DOC
- Cancel additional state police training academy
- Reduce DJJ pass-through funds to support local juvenile corrections
- Reduce aid for police departments

Impact of 15% Option: $85.9 million

- Close James River CC & all field units, eliminating almost 1,300 prison beds and 234 officers
- Lays off 140 state troopers & eliminates all medflight
- Closes Hanover JCC & halfway houses
- Reduce aid for police departments



Final Thoughts

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- All “low-hanging fruit” has been picked
- Hard decisions will have to be made throughout the next biennium
- Standard option of level funding or freezing programs not sufficient to close gap
- ARRA funding provides a partial cushion in FY 2011, but phases out mid-year
- Based on the current economics it will take us into the FY 2012-2014 biennium before we are more structurally balanced
- Sustainable reductions to ongoing costs will have to be made