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State of the Defense Industry

By James Clary, Senior Economist

The Department of Defense (DoD) drives the Hampton Roads economy. The DoD provides a greater share of personal incomes in Hampton Roads than the motor vehicle industry provides in the Detroit metropolitan area. When the DoD changes its spending levels it drives changes throughout the Hampton Roads economy, or more colloquially, when the DoD gets a cold, Hampton Roads gets malaria. To anticipate the path of the regional economy, it is necessary to understand the current impact of the DoD in the Hampton Roads economy, and then to survey both the overall defense budget and strategic decisions as they relate to this region.

The Hampton Roads Defense Industry by the Numbers

Uniformed Personnel

>2013.....	86,504
>2014.....	84,000
>2015.....	82,000

DoD Federal Civilians

>2013.....	44,103
>2014.....	43,800
>2015.....	43,600

Real Contracts Performed (2014 Dollars, 5 year M.A.)

>2013.....	\$9.5B
>2014.....	\$8.9B
>2015.....	\$8.7B

Source: 2013 Bureau of Economic Analysis, 2014 & 2015 HRPDC Estimates

About this Document:

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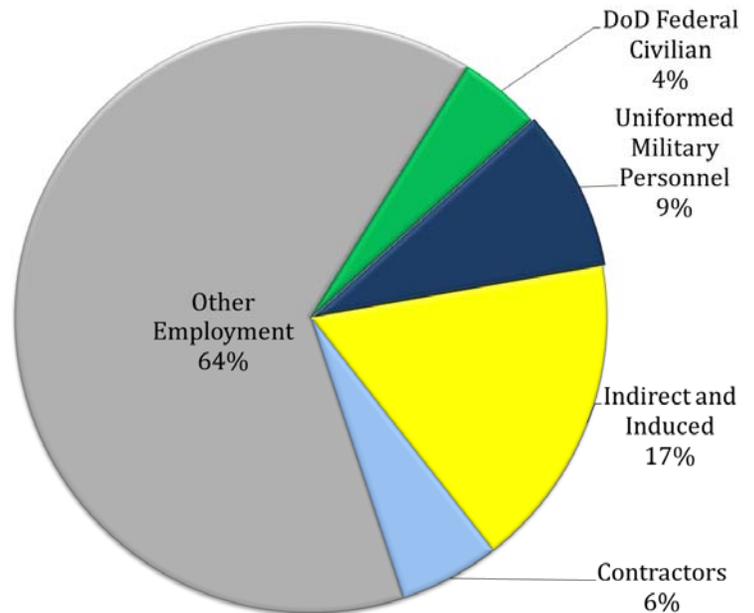
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Available for download, visit www.hrpdcva.gov

Source of Hampton Roads Employment

36%

Of
Hampton Roads
employment was
either directly
employed by or
supported
through DoD



Source: Bureau of Economic Analysis, HRMFFA, USASpending.gov, HRPDC

Measuring the Employment Impact

Uniformed Military Personnel (including Coast Guard)

In 2013, Hampton Roads served as the base for 86,504 uniformed military personnel, representing a decline of 26,865 from 2003. Despite this decline, uniformed personnel still constitute 8.6% of all regional employment and earn 10.2% of the region's personal income. The majority (70%) of \$7.82 Billion personal income earned by the region's service personnel comes as either salary or cash allowances, with benefits comprising the other 30%.

As a result of the relatively high level of total compensation (almost 70% greater than the average regional employee), military employment creates a significant number of jobs throughout the regional economy. HRPDC staff estimates that military personnel in Hampton Roads have an employment multiplier of 1.89. This implies that for every 100 military personnel in the region, another 89 jobs are created through their interactions with the regional economy (their indirect and induced effect). Thus, the 86,504 uniformed personnel in 2013 generated an additional 76,730 jobs regionally, or 7.6% of total regional employment.

Federal Civilians

It is easy to overlook the region's Federal civilians who are employed by the DoD because they do not wear uniforms, but they are an integral part of the DoD and its mission. The DoD and Coast Guard also employ a significant number of federal civilians in this region, accounting for approximately 87% of Hampton Roads 50,780 federal civilian employees. DoD and Coast Guard federal civilian employment constitutes 4.4% of regional employment and 5.6% of regional personal income. Much like the uniformed personnel, the relatively high compensation that the federal government provides its civilian employees leads to a significant number of indirect and induced jobs.

Defense Contracting

Another channel for the DoD to impact the local economy is through government contracts. This includes material directly used in the defense of the country, including ships and submarines, but also increasingly support at the bases,

Compensation in 2013

Average total compensation per job in Hampton Roads: **\$53,260**

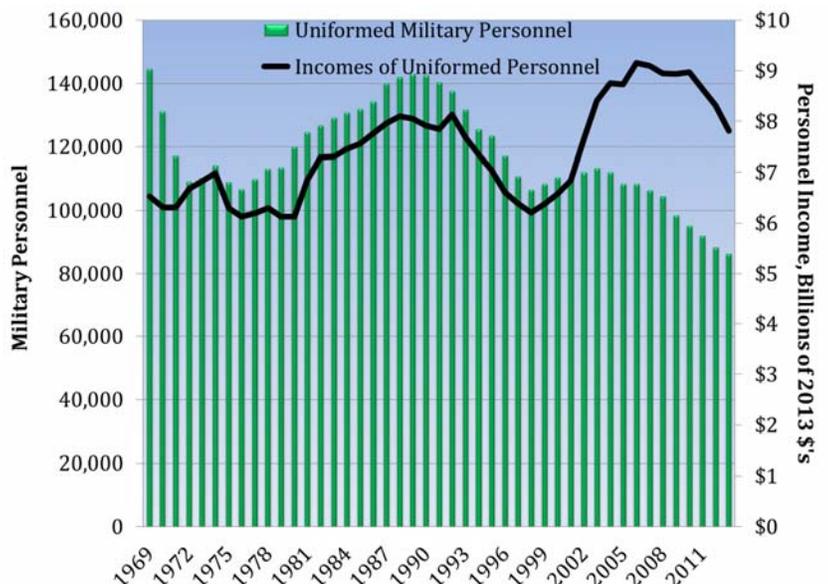
Average total compensation per uniformed military personnel in Hampton Roads: **\$90,364**

Average total compensation per Federal civilian in Hampton Roads: **\$97,596**

Hampton Roads Uniformed Personnel and Income, 1969 to 2013

The number of uniformed military personnel in the region declined starting in 2003, but their personal incomes continued to grow regionally through 2008, only beginning to decline significantly in 2011. The growth in incomes was a result of recruiting and retention efforts during the War on Terror, as well as the increasing cost of benefits.

Source: Bureau of Economic Analysis, HRPDC

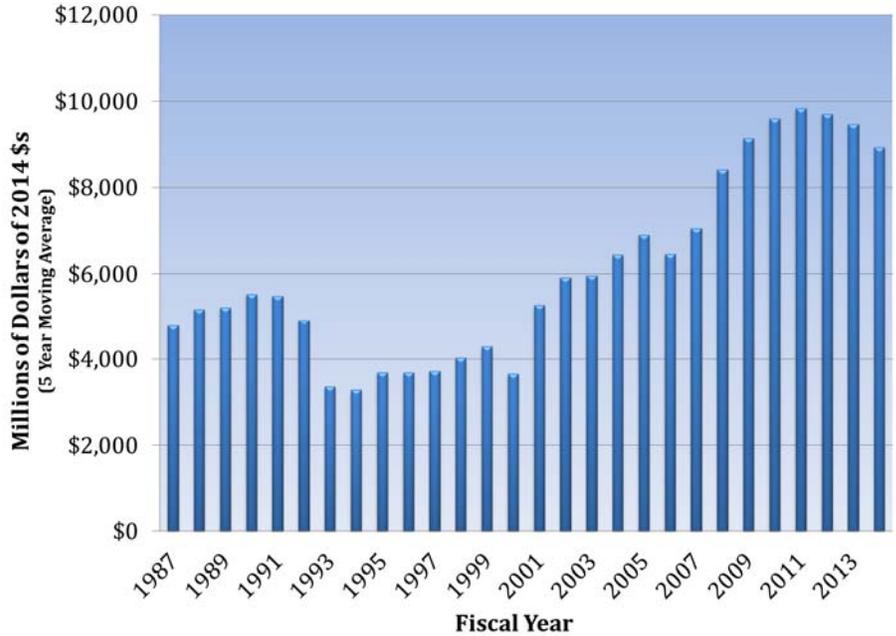


as many of the support roles formerly filled by uniformed military personnel are now filled by contractors. Hampton Roads saw military contracts swell to \$9.5 billion in 2011, but these have declined to \$8.9 billion in 2014. Currently, the HRPDC estimates that the DoD contracts supported approximately 55,000 jobs in the region in 2014, and an additional 49,000 indirect and induced positions.

Total Employment Impact in 2013

Thirteen percent of all employment in Hampton Roads comes from the DoD, and a further 6% of employment comes as a result of DoD contracts performed in this region. Furthermore, an additional 17% of the jobs in this region are created through the indirect and induced impact of the employment that the DoD directly supports in Hampton Roads.

Hampton Roads DoD Contracting



Source: USASpending.gov, HRPDC

Surveying the Future of Defense Spending in Hampton Roads

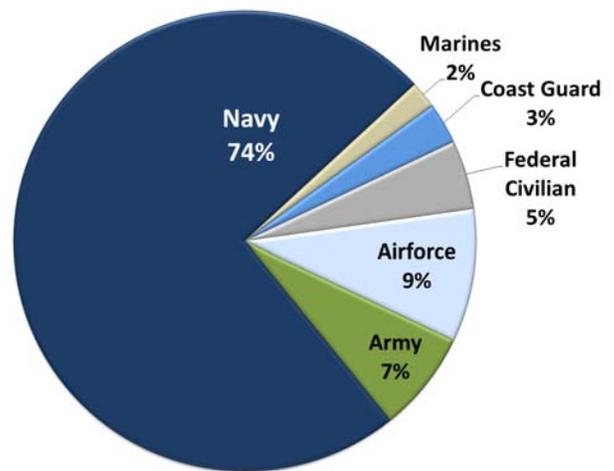
The FY2015 National Defense Authorization Act included \$521B in base defense spending, of which \$482.7B were discretionary DoD appropriations, and an additional \$63.7B for overseas contingency operations. The DoD appropriations are slightly higher than last year (\$1.52B, or 0.3%), but when accounting for expected inflation (consensus estimate of 1.7%), this represents a real decline in defense spending of almost \$6.6B. If this decline were to affect Hampton Roads proportionally, it would indicate a decline of almost 5,000 jobs regionally, with regional earnings falling by \$266 million.

While this represents a significant decline in economic activity, Hampton Roads experienced a similar decline in 2013 and 2014, and has experienced regional growth despite these cut-backs. Furthermore, individual pieces of the budget indicate that the cuts will not be that significant to the region as explained below.

One important aspect of the 2015 budget is that the share of expenditures on each branch are changing, with the Army and Air Force experiencing declines in their budgets, while the Navy will be flat in nominal terms.* Total personnel costs in the budget remained flat, reflecting modest increases in compensation (1% increase in base pay, but a 1% decrease in housing allowance), with fewer personnel overall.

Focusing in on Hampton Roads, several items of good news emerged from some of the finer details, with contracting dollars approved for the Virginia class submarines \$5.83B (a 7.25% increase) and \$781.8M to begin the overhaul of the USS George Washington. The USS George Washington refueling has dual

Direct DoD Employment by Branch



Source: Bureau of Economic Analysis, HRMFFA, USASpending.gov, HRPDC

importance to this region, serving not only as a major contract performed in Hampton Roads, but also making it more likely that five aircraft carriers will continue to be home-ported in Norfolk. Also, while this was part of the 2014 budget, an additional \$663.0M will be allocated for the construction of the Gerald R. Ford (CVN-78) in 2015.

Other changes in 2014 and 2015

Ship movements/decommissionings have two impacts on the local economy: they remove military personnel who would otherwise live in Hampton Roads and they decrease ship repair activities in the region. The USS Iwo Jima and the USS Fort McHenry moved to Jacksonville in September of 2014, and the USS Porter moved to Rota Spain. These movements removed 1,690 uniformed military personnel from local communities. Additionally, the USS Kaufman will be decommissioned in September of this year, and she had a complement of 226 sailors and pilots.

2015 DoD Impact on Hampton Roads

While the pace of loss will slow, we will continue to lose uniformed personnel, with the average for the year falling to 82,000 stationed in Hampton Roads. Ship building and repair contracts constituted 57% of DoD contracts in Hampton Roads, and the contracts discussed above should help prevent a major contraction in DoD contracting performed regionally. Overall, continued slow budget growth and strategic shifts will subtract approximately 5,500 jobs overall from the regional economy.

Impact of a Carrier

Aircraft carriers serve as the primary way the U.S. Navy projects force. Currently, the U.S. has 10 active Nimitz class carriers manned by a crew of 3,200 (an additional 2,500 will be aboard during deployment with the airwing).

Three active carriers return to Naval Station Norfolk as their homeport: the Dwight D. Eisenhower, Harry S. Truman, and the George H.W. Bush. A fourth carrier, the Abraham Lincoln, calls Hampton Roads home as it undergoes its midlife refueling at Newport News Shipyard.

The crew of each carrier earns \$289M per year, and their spending in the region support an additional 2,790 indirect and induced jobs, adding \$570M to the region's Gross Regional Product

Recently, Senator Warner announced that the Gerald R. Ford, currently under construction, will be stationed in the region. It will have a ships company of 2,600 when commissioned in 2016.

A Note About the Sequester

The sequester is simply an automatic and proportional reduction across all Federal Expenditures in the event that budget does not abide by the caps enacted in 2011.

These caps are below what the DoD feels is necessary to meet its strategic mission, and below the levels suggested in the President's FY2016 budget request. Congress has adjusted the caps on two separate occasions, but the budget either needs to meet the current caps, or Congress will need remove/adjust the caps before FY2016.

2016 and Beyond

The President's budget request for \$534B for defense is a significant increase over FY2015, and would increase spending for the Navy by 7.9%, with the majority of that money going to procurement as well as operations and maintenance. It includes continued funding for the George Washington refueling, as well as preliminary funding for a replacement Ballistic Missile Submarine (the Ohio Class), in which Hampton Roads would presumably participate.

The budget is also significantly above the budget caps. Historically, the President's Budget, particular projections into the future, follow the path of Defense spending rather than guiding it. The improving national economy lessens some of the budget pressure, but Congress will have to agree to remove sequester if they want to support the DoD at requested levels.

*While the overall Air Force Budget is increasing, most of that increase goes towards pass through funds. When considering funds that support Air Force operations, the Air Force will experience a 1.2% decline, while the Army will experience a 2.8% decline in inflation-adjusted. The overall Navy budget will decrease by 1.4% in inflation-adjusted terms, but most of that decrease will be experienced by the Marines.

Hampton Roads Economic Outlook:

Employment Improves and Retail Recovers

By James Clary, Senior Economist

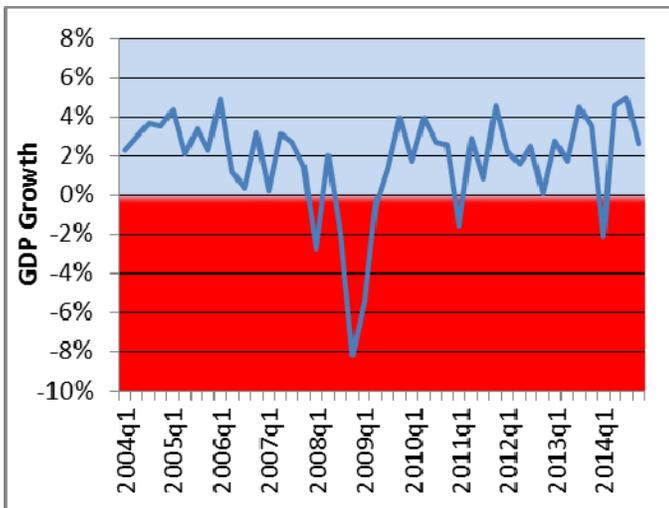
It has been a turbulent seven years, but in several respects the Hampton Roads economy appears to be recovering steadily. This includes consistent growth in regional employment over the past six months, and retail sales that finally have exceeded 2007 levels. Additionally, the national recovery seems to be firmly established, which will buoy both port related industries and tourism in the coming year, as well as easing federal budget issues through increasing tax revenues.

Unfortunately, the modest rate of growth only slowly repairs the damage that the regional economy experienced during the recession. It will be several years before employment reaches the prerecession peak, which continues to create a drag on the housing market. Typically, fixed residential investment helps to bring a region out of a recession, and while construction employment has grown nationally throughout the recovery, regional construction employment has been consistently weak. Some of the weakness in the housing market has derived from cuts in regional defense spending and uncertainty about federal investment within Hampton Roads, but as greater clarity/stability develops with regards to defense, one can expect a more sustained recovery.

Hampton Roads Economic Indicators

GDP, Annualized Growth Rate

United States, 2004Q1 - 2014Q4, Quarterly

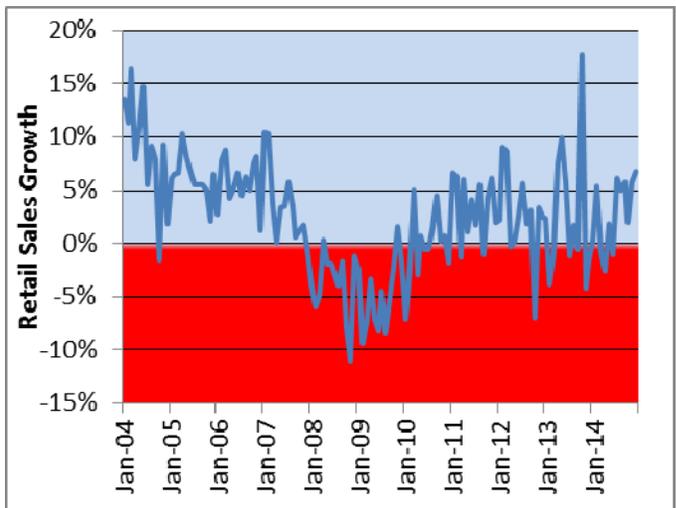


Source: Bureau of Economic Analysis, HRPDC

GDP: Gross Domestic Product combines consumption, investment, net exports, and government spending to determine the size and general health of the economy. GDP growth slowed in the fourth quarter, expanding at an annualized rate of 2.6%. While this growth represents a reduction from the exceptionally high rates the nation experienced earlier this year (4.6% in the 2nd Quarter, and 5.0% in the 3rd), this indicates a sustained recovery that should continue through the next year.

Retail Sales, Year over Year Growth

Hampton Roads, Jan 2004 - Dec 2014, Monthly

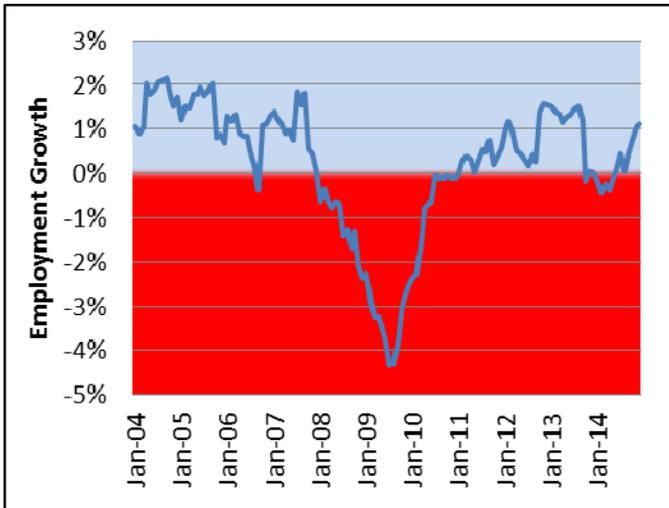


Source: Virginia Department of Taxation, HRPDC

Retail Sales: Hampton Roads' retail sales, as measured by the 1% local option sales tax, serve as an indicator for consumption in the region. Since consumption composes 68% of economic activity in the U.S., the growth or decline of retail sales gives a strong indication of the direction of the local economy. Hampton Roads continues to experience strong retail growth coinciding with the employment growth starting in June of 2014. Regional sales broke through the prerecession peak in September of 2014, and were 1.1% higher than the previous peak in December of 2014 (and 15.4% higher than the trough of the recession).

Employment, Year over Year Growth

Hampton Roads, Jan 2004 – Dec 2014, Monthly

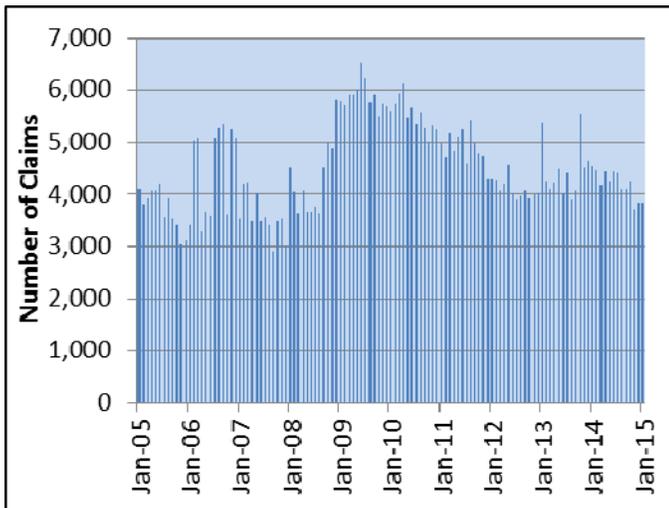


Source: Bureau of Labor Statistics, HRPDC

Employment: Non-agricultural civilian employment figures are considered the best estimate of labor market activity by the National Bureau of Economic Research. Hampton Roads employment grew strongly in the second half of 2014, adding almost 9,000 jobs. The region now needs to demonstrate that it can maintain employment growth through 2015, as employment remains 21,000 jobs below the pre-recession peak.

Initial Unemployment Claims, Seasonally Adjusted

Hampton Roads, Jan 2005 – Jan 2015, Monthly

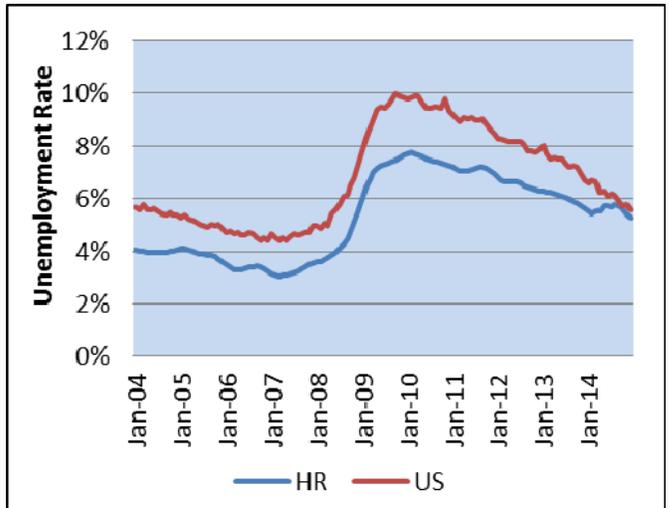


Source: Virginia Department of Labor, HRPDC

Initial Unemployment Claims: The number of Initial Unemployment Claims is a leading economic indicator, reflecting those who are forced to leave work unexpectedly, and thus revealing the strength of the job market with little lag time. Initial unemployment claims have fallen significantly below their long-term average, reflecting the improving outlook for the labor force in Hampton Roads. Lower claims are associated with both fewer firings and greater opportunities for those who lose their job.

Unemployment Rate, Seasonally Adjusted

U.S. & Hampton Roads, Jan 2004– Dec 2014, Monthly

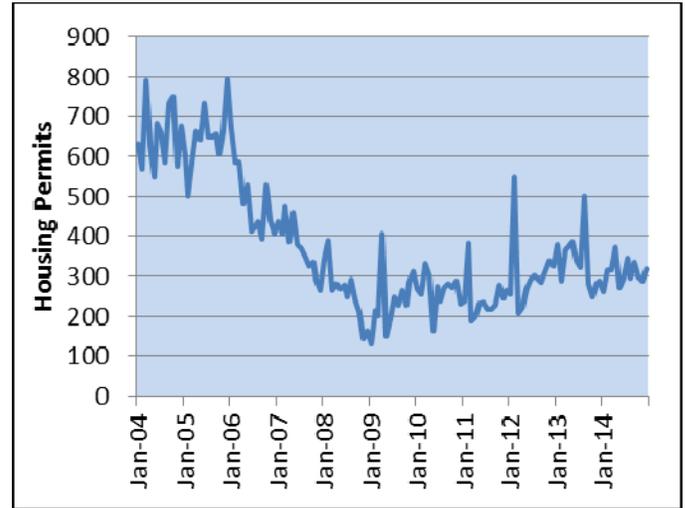


Source: Bureau of Labor Statistics, HRPDC

Unemployment Rate: The unemployment rate is the percentage of the population which is actively seeking work, but is unable to obtain a position. While the regional unemployment rate has improved marginally over the past few months, it has not matched the rapid improvement in the national rate. Two separate trends account for this. First, a stronger labor force participation trend regionally than nationally. Second, unlike the U.S., Hampton Roads' employment has not returned to pre-recession levels.

Single Family Housing Permits, Seasonally Adjusted

Hampton Roads, Jan 2004 – Dec 2014, Monthly



Source: U.S. Census Bureau, HRPDC

Single Family Housing Permits: Permit data signals the level of construction employment and confidence regarding the future trajectory of the local economy. Single family permitting in Hampton Roads remains 33% below the long-term average. This low level of permitting reflects a mixture of factors impacting the real estate market, and weakness in residential investment is expected to continue into the near future.