Remarks of the Honorable Robert F. McDonnell
Governor of the Commonwealth of Virginia
To the Joint Meeting of the Senate Finance, House Appropriations and House Finance Committees
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AS PREPARED FOR DELIVERY
FOR PUBLIC RELEASE

Thank you.

Chairman Stosch, Chairman Putney, Chairman Purkey, members of the General Assembly money committees, ladies and gentlemen: good morning and welcome back.

First, the bottom line, and the good news: Due to our fiscal stewardship working together, I am pleased today to announce that the Commonwealth finished FY 2012 with a total budget surplus of $448.5 million. This is composed of a $129.2 million revenue surplus which I announced last month, plus $187.0 million in savings from unexpended general fund appropriations and recoveries, and $132.3 million in higher education and other unexpended non-general funds that are reported on the balance sheet.

This is the third time that I have appeared before you to review the year-end financial position of the Commonwealth. In these three years, I have announced revenue surpluses and budget savings totaling nearly $1.4 billion. This is a bipartisan accomplishment, and not bad for any state in this uncertain economy. While the crafting of these budgets was hard fought over the past three years, the final product and good results were well worth the debate.

Simply put: Over the past 3 years we have brought in more revenue than forecasted, and spent less than budgeted. That is responsible fiscal management. It is the Virginia way and I congratulate you and all the members of the General Assembly for helping us achieve this result. Thank you!

Here are the details of our financial performance last fiscal year.

For fiscal year 2012, total general fund collections, including revenues and transfers, exceeded the official forecast by $129.2 million. General fund revenues rose a healthy 5.4 percent in FY 2012 compared with the budget forecast of 4.5 percent. To put this in perspective going forward, in the newly enacted biennial budget, general fund revenues were estimated to grow by 3.7% in FY2013 over FY2012. With this current revenue surplus, revenues now have to grow only another 2.9% to meet the budgeted revenue figure for FY2013. That is good news. Also, while total revenues marginally exceeded fiscal year 2008 levels, it is important to note that this is the first time that we have had back-to-back, year-over-year increases in general fund revenue collections since FY 2008. Both of the past years have seen growth over 5%.

The revenue surplus is concrete evidence of the Commonwealth's improving jobs picture and overall economic condition. Virginia's seasonally adjusted unemployment rate has declined from 7.2% in February 2010 to 5.7% today. That's a drop of over 20%. We have the lowest unemployment rate in three years, and the lowest in the Southeast, by a long shot. While Virginia's unemployment rate stands at 5.7% the next closest state in the Southeastern region to us is Alabama, at 7.8%.

Payroll withholding and sales tax collections, which are closely linked to current economic activity and account for nearly 82 percent of the total general fund, exceeded the forecast by $89.2 million. This amounts to about 70 percent of the revenue surplus.

We exceeded the annual forecast in all of the major sources:
Net individual income taxes grew 6.7% in FY2012 ahead of the annual forecast of 5.9%;
Sales and Use Taxes grew 3.6% in FY2012 double the annual forecast of 1.8%; and
Corporate income taxes grew 4.6% in FY2012 ahead of the annual forecast of 0.7%

The fiscal year 2012 revenue surplus is also attributable to reliable fiscal advice, which drove Virginia's consensus revenue forecast process. In the fall of 2011, based on candid analysis from economists, business leaders, and General Assembly members received through GACRE and JABE, we adopted an economic outlook for fiscal year 2012 which anticipated the continuation of slow growth during recovery. The resulting revenue forecast was conservative, which was crucial to our ability to budget responsibly in a complicated environment. And, we did not revise or increase the general fund forecast during the 2012 legislative session.

Our administration continues to focus on productivity and efficiency, and you approved many of our recommended government reforms, consolidations, and savings strategies this session. We directed our agency managers to innovate, be frugal, and not to spend all their appropriations at the end of the fiscal year just because they had the money. Due to the dedication and sacrifice of our state employees, it worked. Thus, on the savings side, there was $319.3 million in unspent general fund appropriations, recoveries, and certain non-general fund balances at the end of June. This compares favorably to the $234.1 million that I reported as the savings at the end of fiscal year 2011. Together we are proving that, unlike Washington, we can balance a budget annually and actually spend less while maintaining quality core services for our people.

Of the $319.3 million in savings, $66.1 million is in balances which come from certain non-general fund accounts that have been traditionally required to be reported on the general fund balance sheet at the end of the year. Approximately $66.2 million of this amount consists of balances in higher education operating funds that are brought forward pursuant to mandatory language specified in the Appropriation Act. The remainder, or $187.0 million, constitutes operating savings from unspent general fund appropriations and recoveries. Specific measures that have contributed to the overall savings include a continuing hiring freeze, incentives to promote individual employee savings ideas as well as better agency performance, the reorganization of both management and operations within many state agencies, and the performance incentive bonus. The need for traditional layers of management has been questioned and modified, and efficiencies through contract reviews are beginning to net savings for the bottom line. This important work will continue through our Government Reform Commission, Cabinet Secretary analysis, and additional external audits of key agencies which you approved at my request this year.

The important question now regarding the surplus is where will the $448.5 million go?

The Constitution, the Appropriation Act and the Code have a number of provisions which specify how most of these additional resources must be allocated. Principally, an additional $78.3 million must be set aside for deposit to the Revenue Stabilization Fund for FY 2014. Which will bring the Rainy Day Fund balance to approximately $689.0 million at the end of the biennium, the highest balance since FY 2008 and the fifth highest annual balance ever. The balance was just $295.2 million two years ago when we began to take steps to improve the Virginia economy and enact structural budget reforms. Another $30.0 million is designated for deposit to the new Federal Action Contingency Trust (FACT) Fund, as a reserve to help us mitigate the consequences of potential federal budget sequestration, and other negative federal actions that could adversely affect Virginia's economy and our future revenue collections. These two actions will help us improve liquidity to nearly $720 million in strategic reserves and guard against any future shortfall in budgeted revenues, and help us as we navigate through the unprecedented uncertainty of federal fiscal policy.

In addition, we will be able to meet several other contingent requirements in statute and in the Appropriation Act. First, we will return $132.3 million to higher education and nongeneral fund accounts where it has been designated. Second, we will allocate another $16.9 million to the Virginia Water Quality Fund to help us meet our obligations under the Watershed Improvement Plan (WIP) to accelerate our efforts to clean up the Chesapeake Bay. Since the beginning of our Administration in FY 2010, we will have deposited or committed to deposit $103.7 million from surplus balances to the Water Quality Improvement Fund. Third, we will return $20.9 million to the Transportation Trust Fund to properly account for transportation's share of the phased-out accelerated sales tax collections received in June. Finally, we will set aside an additional $17.2 million to cover the increase in the state's share of obligations resulting from several natural disasters that occurred over the course of FY2012.

One of the most significant items that we will be able to address as a result of the surplus concerns the 3% performance incentive bonus to state employees included in the Appropriation Act. In the budget bill I introduced to the 2012 General Assembly, I recommended that you include a bonus of up to 3% for state employees if agency savings and unspent appropriations at the end of the year were sufficient to pay it, and if the employee maintained a good performance rating. The idea was to offer state employees a performance bonus if they were able to increase productivity and frugality to achieve sufficient savings in their agencies.

Some versions of the budget, as it progressed through the legislative process, made no provision for this bonus. The final enacted budget included the bonus to be paid from both surplus revenues and unexpended appropriations, which was estimated to cost in full $77.2 million.

As the year-end close out numbers show, the revenue surplus at the end of the year was $129.2 million, but $78.3 million of that total had to be reserved for an additional payment to the Revenue Stabilization Fund in FY2014. In addition, $20.9 million from the revenue surplus had to be set aside for return of transportation's share of the accelerated sales tax, an additional $17.2

million for natural disasters, and another $12.3 million was designated for deposit of surplus revenues to the Water Quality Fund, as required by statute. What this means is that there was not enough in the remaining revenue surplus to cover the cost of the bonus without agency savings.

I remained confident throughout this process that agencies could achieve the required savings in order to implement a performance bonus, as the employees did when I first recommended a performance bonus in FY2010. Earlier this year, I directed our agency heads to identify potential savings and the strategies by which to achieve them. As a result, there were $122.8 million in discretionary general fund balances in agency unspent appropriations. This is more than enough to meet the $77.2 million costs of the 3% bonus. Therefore, we will meet our commitment to eligible state employees, and they will receive a full 3% performance bonus on December 1, as a reward for good stewardship of the taxpayers money.

After five years without a pay raise, I am pleased that we are able to reward our employees with a performance bonus, while simultaneously preserving core services and building up the Commonwealth's cash reserves. Thus, today we have additional positive news to share regarding the Commonwealth's liquidity.

During the three-year span covered by the Great Recession (fiscal years 2007, 2008 and 2009), our unrestricted cash reserves declined by 45 percent from $4.2 billion to $2.3 billion. In response to the fiscal discipline that has governed our joint actions over the last three years, this trend has been reversed. Virginia's available cash reserves have risen 30 percent from $2.3 billion on June 30, 2009, to $3.0 billion on June 30, 2012. This added liquidity is significant, and provides us an added measure of budgetary flexibility, which will bolster bond rating agency favorability as we continue to navigate through these uncertain, volatile times.

Finally, we are moving well ahead of the original schedule to eliminate the accelerated sales tax policy. In 2009, the General Assembly passed the accelerated sales tax. Most of us agree that it is a poor policy, and I have called for its elimination as quickly as is possible. You approved my recommendation to begin to phase out this provision beginning in FY2013. However, starting last year, we took additional steps to speed up elimination even further, by phasing it out two years early. Thanks to your good work this session, we reduced the acceleration by $50.0 million in FY 2012, which means that approximately 96% of retail merchants are no longer transmitting the unfair accelerated sales tax.

In summary, we have now posted three straight budget surpluses totaling nearly $1.4 billion.

The Rainy Day Fund at the end of this biennium will be the largest it has been since FY 2008.

We are rewarding our state employees for their sound management and successful savings strategies with a 3% performance bonus, while saving taxpayer dollars at the same time.

Revenues are up due to economic growth, not tax increases.

I salute you for working with us, across party lines, to make these noteworthy accomplishments happen.

However, as much as we may want to enjoy our improving fiscal situation, we must acknowledge that the way ahead still remains very uncertain. Policies and indecision coming from Washington D.C will potentially have a tremendous adverse impact on all of the states, especially Virginia. Financial crisis in the European Union, changing governments and conflict in the Middle East, and unacceptable rates of national unemployment and debt may create real challenges in FY 2013.

The biggest immediate factor is the potential for devastating, automatic, capricious cuts to our military and defense industry as a result of budget sequestration.

As you know, sequestration is the budget process that the President and Congress set up last summer as a last resort to push Washington toward balancing the federal budget and get a debt limit deal done before a looming deadline. Our nation was on the brink of default. It was an historic and unprecedented time in our nation’s history. It was simply inconceivable that our great nation could be about to exceed its debt limit and default on its credit, with the downgrades and economic chaos that would follow. For that reason, many reluctantly supported the final agreement that passed, not because of what it contained, but because of what it prevented.

It was anticipated by all, that following passage of the debt limit deal, a so-called Super Committee would come together, with leadership from the President, and find a way to significantly reduce national spending, without allowing the automatic defense cuts contained in sequestration to take place. The belief was that the Super Committee would have the time necessary to rationally and wisely fashion a targeted and prudent approach to addressing our nation’s spending and debt crisis. It failed. And now we are on the verge of sequestration taking place; on the brink of another potential fiscal disaster.

This coming January, absent a change in law, automatic cuts are going into effect in the federal budget that will slash military spending dramatically and randomly. By this November WARN Act notices will likely go out to hundreds of thousands of Virginians warning of potential job losses. As reported by the *Richmond Times-Dispatch* on July 18, 2012, a study has suggested that if fully implemented, sequestration could cost Virginia 207,571 jobs, the second highest amount in the nation.

And Virginia is not alone. Due to sequestration, California, Texas, Maryland, Florida, Pennsylvania, New York, Massachusetts, and Georgia all stand to lose a significant number of jobs. A failure to stop sequestration will impact every state in the nation and imperil national security and economic recovery at the same time. In short, we can’t afford, and should fight, sequestration as the way ahead to reducing the national deficit.

We are embarking on a course without precedent in the post World War II era. If sequestration goes forward, we will not be fielding the military that our Pentagon says we need to maintain our current posture. Former Secretary of Defense Robert Gates has said that the cuts would be “devastating” to our national security.

Here in Virginia, this force reduction would be a double blow. We share with all Americans our concern for the safety of our country and for the young men and women who are out in distant battlefields taking risks to keep us safe. But we also will suffer disproportionate consequences given that our state is the home of such a large share of our armed forces.

This policy will have a significant impact on next year's budget and we must continue to push Congress and the President for a well-reasoned solution, now. At the same time, Virginia must prepare for the worst. Our creation of the FACT fund and our efforts to continue to increase the size of our Revenue Stabilization Fund are steps in the right direction toward financial security. Moreover, we must remain committed to creating new jobs whenever and wherever we can in this Commonwealth to promote a healthy and diverse economy that is not overly dependent on any one industry or customer. This is simply a matter of our economic well being. I have also signed EO 39 which creates a commission to plan for ways to help soften the impact of necessary and coming federal budget cuts.

Private sector job creation and economic growth have been and continue to be the number one objective of our administration. Given the uncertainty that now faces us with the prospects of sequestration, it is the "right" objective to promote consensus building across party lines in order to tackle the issues that are most important to all Virginians: gainful employment and economic security. I thank you for your past support of our economic development efforts, and the significant resources you approved in the past three budgets, and hope that you will continue such support as we jointly seek to get our people back to work.

Virginians have always come together at times of great consequence and I believe that we will do so again in the face of sequestration and its negative impacts on our Commonwealth. I am thankful for this underlying spirit because it facilitates the job of governing between branches of government and political parties. I will continue to seek your guidance and advice as fiscal realities warrant over the remainder of my term in office.

Similarly, we must assure all concerned that we have the resources and cash reserves necessary to protect our fiscal integrity, and to guarantee public trust in our financial dealings. Our three-consecutive budget surpluses are a very positive signal to bond rating firms. Our relatively low unemployment rate is also noteworthy. During our January visit to the bond rating agencies in New York, Moody's, Standard and Poor's and Fitch were all complementary of the Commonwealth's longstanding tradition of fiscal responsibility, problem solving, and prudent borrowing. We must continue those traditions by preparing now for future actions of the federal government that we cannot control or accurately predict.

There are also other key state obligations and needs that must be addressed at the same time.

One of our biggest achievements accomplished during this past General Assembly Session was our successful bipartisan effort to stabilize and strengthen the Virginia Retirement System for the thousands of Virginians who depend upon it. By working together with leaders such as the Speaker, Senators Janet Howell and John Watkins and Delegate Chris Jones, we are instituting new reforms that will lower total unfunded liabilities by nearly $9 billion by 2031. That means a more solvent system. It affirms a commitment to our hardworking state employees, teachers, firefighters, police and local employees who are counting on VRS to fund their retirement benefits.

These retirement reforms usher in a new era of options for state and local employees and take major steps toward addressing the rapidly increasing unfunded state and local liabilities of the retirement system, which were estimated by VRS to total nearly $24 billion.

As part of these revisions to VRS, we were also able to fund the highest employer contribution in VRS history, which includes an estimated total of $2.4 billion over the 2012-2014 biennium in employer contributions for state employees, teachers and law enforcement.

These major reforms include changing some of the benefits and providing a new hybrid pension/401(k)-style retirement plan. These reform actions constitute a significant effort to address the existing unfunded liabilities that face Virginia, and help achieve long-term financial security for the Commonwealth. As a result, Moody's Investor Service quickly issued a notice citing our reforms as a "credit positive."

All state employees were required last year to begin contributing 5 percent of their salaries toward their pensions, which was offset by a 5 percent raise. This year's legislation, as amended, expands that contribution to include local employees who are in VRS. The mandatory contribution is offset by a pay raise from the localities, which can phase-in the requirement and the pay raise over 5 years. The Commonwealth will also begin to increase the employer contribution rate for the existing defined benefit plan, so that over the next 6 years it conforms to the actuarial recommended contribution rate using a 7 percent investment yield assumption.

Under these provisions of the VRS reform legislation, an employee will take a personal stake in their retirement and invest a portion of their paychecks toward their future financial security. Risks will be shared between the employer and the employee. Responsibility will be delineated and accountability will be enhanced.

As I pledged to everyone here at this time last year, significant pension reform was one of my main priorities for last session, and although it was a challenging process, we were able to come together and agree on a long-term solution for our retirement system. Thank you for your effort.

In education, I thank you for your partnership as we strive to improve outcomes for all age levels – starting in kindergarten and continuing through college. The new biennial budget includes an increase of $655.1 million in direct aid and we continue to work to increase the dollars that go into the classroom and truly impact student outcomes. With your help, through legislation, we implemented significant K-12 and higher education reforms to make sure that, upon graduating from high school, our students are college or career ready. We have increased the access and affordability of a college education for Virginia students.

Together we laid groundwork to increase educational options for our young people through legislation that facilitates the expansion of high-quality public charter schools, virtual schools, and college partnership laboratory schools. We also opened the door for low-income students who otherwise might not have access to a high-quality education to have the opportunity to attend a non-public school by providing tax credits to companies that contribute to the educational improvement scholarship fund. Through legislation and full funding of the Early Reading Initiative we can better ensure that every third-grader is provided reading intervention services before moving on to fourth grade. Reading is such an essential skill and we cannot let our young people fall behind at an early age. Your approval of investments to increase our

STEM focus, implement pilot programs in merit pay and character education, and increase the number of Governors Schools and career and technology schools are to be commended.

It is critical that we are preparing our students for the highly-skilled, highly-technical jobs of the 21st century, while making sure that they are able to compete in this global economy. Last year, your unanimous support of landmark higher education legislation, *The Virginia Higher Education Opportunity Act of 2011 or Top Jobs Act of 2011*, provides a roadmap for an additional 100,000 degrees from our colleges and universities over the next 15 years, with a focus on STEM-H degrees. Because of this legislation, more Virginians will have the opportunity to go to college than ever before. We are already seeing the results.

The legislation also established a framework for sustained reform-based investment in our colleges and universities to increase access and affordability for our students. This framework, and the $100 million investment in FY 2012 and the $230 million of new resources in the upcoming biennium will help reign in rising tuition costs and end the cycle of disinvestment in our higher education system. In a few weeks, as students prepare to return to campus for another year, undergraduates at the Commonwealth's public colleges and will experience the lowest tuition and mandatory fee increase in a decade. The average tuition increase of 4.1 percent represents a dramatic drop from last year's average tuition increase of 7.9 percent, and well below the unsustainable average annual increase of 9.1% over the past decade.

The budget this year also contains a new incentive, initiative, and performance based funding model for higher education, as well as a requirement for university productivity enhancements through a reallocation of resources to the TJ 21 goals. The strong partnership with our university presidents and boards is making these reforms a success.

Another critical priority for us is addressing the Commonwealth's transportation challenges. Upon taking office, we conducted a Comprehensive Performance Audit of the Virginia Department of Transportation. This audit identified over $1.4 billion in funds that have since been invested in the Commonwealth's roadways, and made over 50 recommendations to help streamline VDOT operations, most of which have been implemented. Last year, working across party lines, we laid the groundwork for the largest investment in transportation in decades. By accelerating the issuance of previously authorized CPR Bonds, authorizing new GARVEE bonds, and creating the Virginia Transportation Infrastructure Bank, all at a time when interest rates are at near historic lows and construction prices are substantially below estimates, VDOT is moving forward with over 900 projects all throughout Virginia.

For example, last week I participated – along with some of you here today – in the groundbreaking ceremony for the I-95 Express Lanes Project. This long stalled project will finally deliver much needed congestion relief and transportation choices to one of the most congested corridors in the country. Further, construction of this project will grow the Virginia economy by $1.5 billion, lead to $464 million in new personal earnings for workers residing in Northern Virginia, and support more than 12,600 direct and indirect jobs.

Together, we are making progress in addressing our transportation needs, with much more still to be done.

Virginia has been a national leader in weathering the recent economic storm.

Our unemployment rate has fallen to 5.7%, lowest in the Southeast, down over 20% since we took office.

We've turned $6 billion in shortfalls into three-straight surpluses totaling nearly $1.4 billion.

We've put the most new funding into transportation in a generation.

We've invested significantly in higher education, and this year we see the lowest annual increase in tuition and fees at our public colleges and universities in a decade.

We've facilitated economic growth and we haven't raised taxes.

We've budgeted wisely, invested smartly in the core functions of government and made Richmond more efficient through government reforms.

Growing our economy and getting government spending under control: Those are the twin goals we have worked towards together over these past few years.

We will continue to offer new ways to create savings and efficiencies, and we will continue to invest in education, transportation, public safety, and economic development, the core government functions. Next year's budget and legislative priorities will all be aimed at laying a solid foundation for growth and opportunity in the future.

Throughout the past three years you have been tremendous partners and leaders in this bipartisan work.

Our collective work has resulted in back-to-back-to-back revenue surpluses and budgetary balances totaling nearly $1.4 billion. We should celebrate these Virginia successes.

Working together, I know we will continue to achieve good things for the people of Virginia. And we will continue to make this a stronger "Commonwealth of Opportunity" for all our citizens.

Thank you