Chairman Callahan, Chairman Chichester, Chairman Purkey, members of the General Assembly, ladies and gentlemen: Good morning.

2007 has already been a remarkable year in Virginia history. We began the year together at the site where, 400 years ago, a new nation began. And we showed, in the legislative session, that Virginia’s leaders are still willing to work together through difficult challenges to move Virginia forward.

Together, we expanded health care access to more children and expectant mothers, and we took more than 140,000 Virginians off the tax rolls.

We worked to provide more resources to clean up the Chesapeake Bay, bringing our total investment to nearly a half billion dollars since 2006.

We began a new approach to early education with pilot projects that are already demonstrating how the public and private sectors can work together to make high-quality pre-kindergarten available to more Virginia four-year-olds.

And together, we reached a compromise on transportation that will allow overdue investments in our road, rail, and public transit network, while encouraging development in ways that move traffic more efficiently.

In the spring, we saw a sad chapter added to our history, when a disturbed young man at Virginia Tech took the lives of 32 students and faculty, wounding many more. As the world watched, the students at Virginia Tech stood together, supported each other, and made us proud to be Virginians.

In May, we reopened our historic capitol and hosted Queen Elizabeth and President Bush, as the world celebrated the four hundredth anniversary of the founding of America with us.

And just this month, we bore witness to the life of a Virginian who did so much to extend the promise of the words all men are created equal to all Americans. Oliver White Hill’s life spanned a full quarter of our Virginia history, and he transformed the way that we live.

In 2007, we have much to be thankful for. Virginia has received a number of accolades in 2007, but I want to mention two of them in particular, because I think they are the most important.
Early in the year, Education Week pronounced that children born in Virginia have a better chance of life success than those born in any other state in the nation.

And just a few weeks ago, Forbes.com named Virginia the number one state for business again. A bipartisan focus on keeping taxes low and supporting entrepreneurship has created a business climate where innovation thrives and opportunity abounds.

We can celebrate these achievements, but I also consider them to be challenges.

In flush times, we have worked together to invest in education and economic development, and to reduce the tax burden on our citizens.

We must work together equally hard if not harder in tighter times, to spend wisely and within our means. We must also look closely at what our state government does to identify opportunities for efficiency and savings. As we move forward, I ask that we again work together to make hard choices necessary to preserve our quality of life.

Last year, when I stood before you to deliver news about Virginia’s economic outlook, our revenue growth was outpacing expectations. As you all know, while our revenues are still growing, due to certain economic trends, the growth has slowed and may stay slow into the next biennium.

In addition to the challenge posed by slowing economic growth, some of the significant cost drivers we identified last year will continue to rise in the foreseeable future, including education and health care costs. We need to take appropriate steps to deal with this natural cyclical change in the current budget and in preparation for the next and we have put in place a performance-driven budgeting system to do so. If we take the necessary steps and prepare a biennial budget based on performance and targeted investments, there is every reason to believe that we can continue to have a thriving economy and a government that serves people well.

Let me start by talking about our current economic position and some of the rising costs we face, and then I will tell you some of the steps we are taking in the current year and as we prepare the biennial budget proposal.

**Economic Trends**

Virginia is entering its fifth year of economic expansion. But we are now seeing the signs of slower rates of growth in jobs and income, and we expect moderate growth in the overall economy.

In fiscal year 2007, revenues grew 4.9 percent, compared to an anticipated 6.5 percent growth rate. This translated into $234 million in anticipated revenues that did not materialize.

The housing sector, which started slowing last fiscal year, continues to struggle. As you know, most of our metropolitan areas are experiencing significantly slower housing sales and fewer new housing starts. As a result, recordation tax revenues are down 16.1 percent from last year.
The cooling housing market also contributed to reduced sales tax and corporate income tax growth.

Slowing income growth, together with increased utilization of the land preservation tax credits contributed to the 21.6 percent increase in income tax refunds this year.

In 2003, you passed legislation requiring a revenue reforecast whenever corporate, individual, and sales tax collections are more than one percent below the aggregate amounts forecasted for those sources. Revenues in these three sources were 1.2 percent less than the forecast.

In June and July, we met with the Governor’s Advisory Board of Economists, the Governor’s Advisory Council on Revenue Estimates, and individuals engaged in the housing industry to discuss their outlook for the next few years.

What we learned from those meetings is that the economy of Virginia remains sound, but the housing sector will take a few years to rebound. Accordingly, we have adjusted the forecast for fiscal year 2008 and the next biennium.

The revised fiscal year 2008 forecast, combined with the fiscal year 2007 shortfall of $234 million, leaves us with an aggregate revenue shortfall of $641 million to address immediately. In addition to compensating for this shortfall, we must also make some adjustments to our base spending, as we anticipate a slower rate of growth for at least the first year of the next biennium. This means that one-time solutions employed this biennium will not be sufficient to place us on the proper course for the 2008-2010 budget.

**Meeting Our Commitments**

We face significant challenges in the next biennial budget as expenses grow in some of our largest programs. We know that the single largest increase in spending will be the costs of rebenchmarking the education Standards of Quality. This investment supports our teachers and our local public schools, securing the quality of our children’s education. And, the strength of our education system has direct bearing on future economic growth.

Thus far, the Board of Education has indicated that routine updates with no changes in policy are going to cost an additional $1.1 billion over the next biennium. This is an early estimate, made prior to normal updates in the composite index, as well as other adjustments, which may increase that number.

We know that we also have significant fiscal commitments to Medicaid and programs funded through the Comprehensive Services Act that will require increased investment.

I also foresee the need for critical new investments in the coming biennium in mental health and education.
Strengthening Virginia's mental health system is imperative. I am awaiting the Virginia Tech Panel’s report, scheduled for release later this week, as well as recommendations from the Chief Justice's Commission and legislative proposals to fully develop my budget for this biennium.

Preliminary analysis of the tragedy on April 16 shows that we need to strengthen emergency services and ensure that treatment is available and reliable in the community. And we need to focus on preventing future tragedies by strengthening our children's mental health system.

We also have the opportunity to make a critical investment in preparing Virginia children for school. Building on the Virginia Preschool Initiative, which you began in 1997, and the public-private pre-kindergarten pilots that you approved last year, I will propose a targeted expansion in pre-kindergarten that allows more at-risk four-year-olds to have access to high-quality education.

The expansion will occur through creative partnership with existing public school programs, Head Start, and the myriad of high quality providers in the Commonwealth. By expanding access to the Virginia Preschool Initiative and building quality in all public and private settings, we will effectively reach nearly two-thirds of all Virginia’s four-year-olds.

Today’s four-year-olds will only be four once, and we will not get another chance to provide them with their best opportunity for success. We know that research shows 90% of brain development occurs before a child turns 5 and that if a child is unable to read by the third grade, his or her chance of success throughout the rest of school is dramatically reduced.

Each year that we wait, another group of children will enter the public school system unprepared. And since we know they likely will require costly services in future years to get on level with more prepared students, each year we wait, we lose the opportunity to use our education dollars more wisely.

**Immediate Steps**

Now, let me tell you what we are already doing to address the shortfall. In May, when it first became apparent that revenues would be lower than expected, I asked agencies to curtail discretionary spending and to dedicate the resulting savings toward any potential budget reduction that they might face in fiscal year 2008.

I am further directing agencies to obtain Secretarial review and approval before hiring any new employees, with some required exceptions. I am also directing agencies to seek review and approval from their respective Secretary before initiating or renewing any existing contracts for consultants or contract personnel.

In addition, I am asking all state agencies to meet with Cabinet Secretaries and the Department of Planning and Budget to explore ways to reduce their operating budgets by five percent. This will include a five percent reduction of the Governor’s Office operating budget.
It would be inappropriate for me to place these demands on our state agencies without asking for some sacrifices from non-state agencies, as well. Accordingly, all fiscal year 2008 non-state agency grants will be reduced five percent.

I will also consider recommending a withdrawal from the revenue stabilization fund, through the caboose budget bill. The Rainy Day Fund was set up to help the Commonwealth during times of revenue shortfall. A withdrawal would still leave the fund at near record levels, due to the contributions we made to the fund in 2006 and 2007.

**Addressing the 2008-2010 biennium**

If all we needed to do now was address the revenue effects of a slower economy this biennium, we could bring the current budget into balance by adjusting capital spending, utilizing the revenue stabilization fund, and managing the carry-forward of unspent appropriations from last year. Our problem could be solved fairly quickly if it was limited to just last year and this year, and it would be tempting to approach this challenge in the way that spares the most short-term pain.

However, this is not the case. Using short-term strategies to balance the budget in the current biennium will not put us in the position we need to be in for the next biennium.

As we look ahead to budget for 2008-2010, we will need to closely examine programs to see if there are any that should be changed or discontinued. We will need to look to new ways of doing business that are more efficient, and we will need to carefully prioritize how we use the funds we have available to us.

As public servants, one of our obligations is to give Virginians our guarantee that we are putting their tax dollars to the best and highest use by providing services and programs that meet our standards for excellence.

Our goal is to be the best managed state, but also to go beyond to measure state government against the best private sector organizations. All highly effective organizations regularly review their budgets and procedures, constantly looking for ways to improve and implement best practices. This exercise is even more crucial in the current fiscal environment.

Since taking office, my Cabinet and I have worked with our agencies to establish specific performance targets and to work toward aligning agency resources to achieve those targets we call this Performance Management. This effort has been ably led by my former Chief of Staff, Bill Leighty, who served the Commonwealth in so many ways, and my current Chief of Staff, Wayne Turnage, whose many years of experience in state government, including a long tenure at JLARC, has given him tremendous insight into this process. I am pleased to tell you that the agencies are incorporating performance management into their daily activities, and we are seeing improved results in many areas.

We will examine all operations to determine which activities truly create value for Virginians. No government program should be funded simply because it has always been funded before.
At the same time, we cannot ignore opportunities to make smart investments to serve citizens better, strengthen our economy, and secure our quality of life. Slower revenue growth is no excuse for stopping the continuous improvement of state government.

Conclusion

The challenges we face are significant, but they are also manageable. We will meet them in a way that doesn’t just see us through the current fiscal year, but puts us on a strong footing for the future. We will make state government more efficient and more effective, and we will make the critical investments that are necessary for future growth.

We have demonstrated that, working together, we can make progress on the Commonwealth’s most daunting challenges. I believe that we have the tools and the will we need to keep our great Commonwealth moving forward.