December 17, 2008

The President of the Senate of Virginia
The Speaker of the House of Delegates of Virginia

Gentlemen:

I am pleased to submit my proposed amendments to the 2008-2010 biennial budget, which will be contained in House Bill No. 1600 and Senate Bill No. 850.

Clearly, this is a time of tremendous challenge for the Commonwealth and for its citizens. The national economic recession is hitting families and businesses across the Commonwealth and the slowdown in projected revenue for their government is a reflection of the challenges we all face. In an economy like this one, citizens and businesses are tightening their belts, looking for savings, and spending only on those things that are most critical. Government should do the same.

Therefore, my proposed revisions to the current biennial budget reflect a government that lives within its means. Over the course of the past two years, Virginia’s government has worked proactively to manage the budget in a difficult time. As the economy has slowed, agencies have found savings in every area of state government – streamlining services, consolidating administrative functions, renegotiating contracts, freezing hiring, and merging agencies. Together, we have kept the budget balanced without a general tax increase and without compromising the core services that Virginians depend on.

We have been in an expense cutting mode since the spring of 2007, when we first recognized the signs of an economic slowdown. I gave agencies a directive to save money and we have been in a continuous period of intense budgetary review since that time. In August, I told you that I intended to accelerate the revenue forecasting process so that I could begin to take necessary steps to reduce expenditures. In September, we held meetings of the Governor’s Advisory Board of Economists (GABE) and the Governor’s Advisory Council on Revenue Estimates (GACRE) to reach a consensus revenue forecast. Based on the advice I received from this group of academic, business and legislative leaders, I announced on October 9th that we would reduce biennial revenues by $2.5 billion immediately and revisit this projection in connection with preparing the budget that I present to you today.
At the time I announced the revenue re-forecast in October, I implemented $358 million in annual spending reductions, proposed a withdrawal from the Revenue Stabilization Fund, and proposed the use of bonding for some capital outlay in order to ensure that the fiscal year 2009 budget remained in balance. In early December, we reconvened GABE and GACRE as promised and reviewed October and November economic data. At that time, the actual data and our economic models suggested that additional downward adjustments would be prudent due to the likely softening of sales receipts and recordation taxes and uncertainty over the non-withholding portion of income tax payments.

Based on that data and our discussions, we have revised the official forecast in this budget downward by an additional $138.6 million in fiscal year 2009 and an additional $229.6 million in fiscal year 2010. These adjustments result in a total general fund revenue reduction in the biennial budget passed last spring of nearly $2.9 billion.

To help address this shortfall, my introduced budget proposes drawing $490 million from the Revenue Stabilization Fund to help balance FY 2009. On July 1, 2008, the Revenue Stabilization Fund had a balance of $1.015 billion. The Constitution of Virginia allows a withdrawal of up to one-half of the Fund’s balance or one-half of the projected shortfall, whichever is the lesser. My proposal is less than what can legally be withdrawn from the Revenue Stabilization Fund. The balance in the Revenue Stabilization Fund at the end of FY 2009 after withdrawing the $490 million proposed in my budget will be approximately $570 million. The budget does not rely on any withdrawals in fiscal year 2010, so that the fund remains available in 2010 if there is any further slowing in the economy.

**Making Government More Efficient**

My proposed budget continues to streamline government and make it more efficient and effective. While this round of budget reductions includes some areas that were previously exempted – like K-12 education – this budget follows a set of principles, designed to address the shortfall, while preserving the essential services state government provides. These principles are what have earned the Commonwealth a national reputation for fiscal responsibility, and recognition as the nation’s best managed state.

First, wherever possible, the introduced budget proposes real, long-term savings instead of using one-time actions. While this approach means that the choices are sometimes difficult, it also ensures the long-term health and stability of our state finances.

Second, the budget avoids across-the-board cuts in favor of a targeted approach. I looked closely at each agency, asking hard questions about the performance and efficiency of programs. Taking a targeted approach means that cuts have been focused, as much as possible, in areas that do not affect essential services. Finally, my Cabinet and I have looked beyond simple
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efficiencies to a deeper discussion of the policy choices that drive costs in our agencies and programs.

The introduced budget includes more than 1,000 layoffs, split approximately equally over the two years of the biennium. Changes to higher education and shortfalls in nongeneral fund transportation revenue will result in additional staff reductions in those areas. I have proposed additional mergers of state agencies when possibilities for greater efficiency exist—the introduced budget merges the Human Rights Council into the Department of Labor and Industry. It also combines the Department of Human Resource Management and the Department of Employee Dispute Resolution.

My budget also preserves funding for the Productivity Improvement Fund (PIF), a seed fund to transform the way we deliver services at lower cost. To date, our $3.4 million investment across 28 projects will deliver $9.8 million in savings over three years for a 2.9 to 1 return on investment.

**Growing Virginia’s Economy**

Balancing the budget while meeting the needs of Virginia’s citizens in the long run depends on growing the Virginia economy. My proposed budget contains several key features designed to stimulate economic growth. It takes lesser reductions in economic development agencies and programs than from other agencies. It also calls for a $5 million increase in the Governor’s Development Opportunity Fund, the Commonwealth’s primary job-creation incentive fund.

I have also proposed increasing the caps on the Virginia Investment Partnership Act, a fund designed to attract major business headquarters, and extending the Major Business Facility Jobs Tax Credit. In addition, I have proposed a new income tax credit and a new sales tax exemption designed to attract new green industry jobs to Virginia, which are reflected in the budget bill.

**Protecting the Classroom**

In all the previous rounds of budget reductions, we have been able to avoid making significant reductions to K-12 education. And while it was not possible to avoid some reduction to the single largest expenditure in our budget in this round, my proposed budget has as little impact on the classroom as possible.

I believe it is prudent to allow our public schools to get through the current academic year without disruptive adjustments to their budgets; therefore, the proposed budget reductions are for fiscal year 2010, which will give school divisions time to plan accordingly. Also, in order to cause as little disruption to children’s education experience as possible, my proposal protects funding for classroom instruction, by focusing on administrative efficiencies.
Specifically, my budget places a cap on state spending towards educational support staff. This cap would be based on a ratio of one support position to every 4.03 instructional positions – based on a 3-year linear weighted average ratio of school divisions' prevailing practice. Despite the detailed formulas that have existed in the state budget for funding classroom expenditures, there has never been a formula to directly control spending for administrative expenses. Taking this forward-looking step now will ensure that more scarce state educational dollars go directly to the classroom. Along with the cap, the proposal includes a loss reduction clause to ensure that no school is unduly affected under this change. This focus on administrative efficiency will save over $340 million.

*Keeping Higher Education Affordable*

Because of the size of the revenue shortfall, it was necessary to make difficult cuts to higher education in Virginia. However, my budget proposes smaller cuts to higher education in fiscal year 2009 than many other agencies received. I have publicly called upon the colleges to acknowledge that by refraining from raising tuition in mid-year. Also, while four-year colleges and universities receive a 15 percent cut in the second year of the proposed budget, the community colleges and Richard Bland receive only a 10 percent reduction.

One of the few new spending items in the entire budget that I have proposed is nearly $26 million in additional money for student financial aid. This money helps to fund the Partnership Model, a formula devised by the State Council of Higher Education for Virginia to determine how much financial aid is needed at each institution. This additional funding would bring every institution up to at least 65 percent of the Partnership Model’s goals. My introduced budget also includes increases in the Community College Transfer Grant program, helping more students begin their higher education at a two-year college and then transfer to a four-year institution to get their degree.

*Holding the Line on Health Care*

Even though Virginia’s Medicaid program is very lean – 47 other states spend more per capita on Medicaid than Virginia – costs are now projected to rise above the previously budgeted forecast by $268 million general fund, even as overall state revenues decline.

My introduced budget limits the reductions in direct services as much as possible. Some services will now have caps, limiting enrollment growth, though not displacing persons currently being served. Many provider reimbursement rates have been frozen or even reduced. Other planned new services will be delayed. These proposed actions will save a total of $418 million general fund in Medicaid.

In order to keep from removing patients currently covered by Medicaid, my budget proposes a 30 cents-per-pack increase in the tax on cigarettes. The Centers for Disease Control and Prevention estimate that cigarette smoking causes over $400 million per year in Medicaid expenses for Virginia. The current cigarette tax raises only about $167 million for Medicaid.
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The proposed increase would generate about $150 million for the Health Care Fund, which supports Medicaid. Rather than reduce health care services for low-income Virginians, the proposal to increase the cigarette tax will bring tobacco products closer to paying for the costs that they create. A 30-cent increase will leave Virginia’s cigarette tax well below the national average.

Finally, my proposed budget does not reduce the gains made last year in investments in community-based mental health services, and continues to move the Commonwealth’s focus from institutional care to community-based care.

**Keeping our Communities Safe**

Because our front-line law enforcement officers are so important to keeping our communities safe, my proposed budget limits the reductions for sheriffs’ deputies’ and Commonwealth’s attorneys’ offices, and local police through the HB 599 program to approximately seven percent, about half what most agencies across state government are taking. My budget also includes closures of Department of Corrections’ facilities—the older and smaller facilities that were announced in the October executive budget reductions.

I have included a smart, cost-effective adjustment to sentencing policy that will protect public safety while reducing the cost of maintaining the state corrections operations. The budget bill extends the department director’s flexibility to grant early release, from 30 to 90 days, for inmates convicted of nonviolent crimes. This small change continues to protect the public, and could result in budget savings and less overcrowding in state prisons and local jails.

**Transportation**

Virginia’s transportation budget is supported mostly by nongeneral fund revenue. My introduced budget reflects changes in the revenue forecast for transportation. The Virginia Department of Transportation (VDOT) will reduce central office staff and streamline operations around the state to respond to the reduced revenue forecast. Over the next three years, VDOT is expected to reduce agency employment by between 900 and 1,150 employees, through retirements, attrition, and other restructuring. The Commonwealth Transportation Board will soon announce a revised Six Year Plan to balance proposed construction and maintenance expenditures against proposed revenues.

**Fiscal Responsibility**

Virginia has faced unprecedented revenue declines during this national recession, yet we have both acted decisively and swiftly to trim spending accordingly, and produce a balanced budget. Our willingness to make difficult decisions promptly has not gone unnoticed. Governing Magazine affirmed Virginia’s status as the top-performing state government in America earlier this year. We recently went into the bond market and had our Triple A bond rating reaffirmed by every ratings agency—a tribute in part to our strong track record in revenue
forecasting and debt management and our willingness to make performance-based budget decisions. These achievements are also proof that while times are not easy, Virginia is in a better position than many states because we have taken an aggressive, proactive approach to our economic challenges and have already taken important steps to reduce spending.

I look forward to working together with members of the General Assembly as we develop and implement a budget that well-serves the citizens of our Commonwealth.

Sincerely,

Timothy M. Kaine