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Governor Kaine Announces Revenue Reforecast, Plan to Address Shortfall *– Shortfall for the biennium approximately \$2.9 billion –*

RICHMOND – Governor Timothy M. Kaine today released the state's official revenue forecast and announced measures to address the shortfall in a speech to the Joint Money Committees. Below are his prepared remarks:

"Chairman Putney, Chairman Colgan, Chairman Purkey, and Members of the General Assembly: Good Morning.

National Economy

We meet in a time of tremendous challenge for the Commonwealth and its citizens. The national economic recession is being felt by families and businesses across the country. As citizens and businesses bring in less revenue, government revenues decline. And, just as citizens and businesses have to tighten their belts and live within their means, state governments must do the same. This is a time for calm resolve to make tough decisions that will position us for a better future.

The current recession is shaping up to be longer than any other recession since World War II. In the third quarter, the nation saw the largest drop in consumer spending since 1980. Payroll employment has fallen for eleven consecutive months. Since January, the national economy has lost 1.9 million jobs, with the unemployment rate rising to 6.7 percent in November. The manufacturing sector has been hit particularly hard. The Institute for Supply Management's index has fallen steadily since June and stands at its lowest level since the early 1980s.

Virginia Economy

In Virginia, our economy is outperforming national trends. We have been named the best state for business for the third year in a row by Forbes.com and we continue to attract great new economic opportunities to the Commonwealth. We recently went into the bond market and had our Triple A bond rating reaffirmed by every ratings agency—a tribute to the relative strength of our economy, our strong track record in revenue forecasting and debt management and our willingness to make performance-based budget decisions.

But, while Virginia's economy is still stronger than the nation's economy as a whole, we are definitely feeling the effects of the national downturn. The consensus opinion of the various boards and experts consulted has been that the economy in Virginia will continue to be sluggish at least through the end of calendar year 2009.

In employment, Virginia has not seen the net job loss that has occurred throughout the nation. But, the rate of job growth is very low. The Virginia economy added 20,600 jobs in October, for growth of 0.5 percent. Growth over the last few months is the slowest since fiscal year 2004. The unemployment rate has averaged 4.4 percent over the first four months of fiscal year 2009, which, while significantly lower than the national unemployment rate, is the highest rate in Virginia since 1996.

The housing market continues to be troubled. Some data suggests that the market may have bottomed out, and we are even seeing some signs of a housing revival in certain communities, but the threat of more foreclosures and tight credit markets still causes concern.

Revenue Forecast

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 and the Governor's Advisory Council on Revenue Estimates 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 budget revenues by \$2.5 billion immediately and revisit this projection in connection with preparing the budget I present to you today.

At the time I announced the revenue re-forecast in October, I implemented \$358 million in annual spending reductions. I also proposed a withdrawal from the Revenue Stabilization Fund and 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. Sales tax revenues were falling behind projections, but income tax withholding collections remained stronger than projected. 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.

There has been at least some suggestion that we should depart from the empirical model that we use for forecasts and take the revenue estimates down even further because of anxieties about what is happening in the national and world economy. I do not believe this would be a wise choice.

We have a data-driven revenue forecasting process that works and includes well-defined opportunities to consider and re-adjust revenue forecasts, if necessary. No forecasting model is perfect, but our process has led us to receive top recognition by virtually every outside organization that analyzes state finances. The recent Triple A reaffirmation we received proves this point.

And we have to remember that departing from the data and cutting deeper because of our anxieties would mean real harm to real people. This tough budget already contains hundreds of layoffs—there's no compelling reason to lay off more state and local employees "just in case." My proposed budget already cuts spending in virtually every area of state government—there's no reason to carve deeper into core services to vulnerable people "to be on the safe side." If the data in February suggest the need to go deeper, we have the will and the tools to do it. We demonstrated that last February when I recommended additional revenue and budget cuts of \$1.4 billion at that time and you largely accepted those proposals. In short, now is not the time for panic. We should stick with the sober, business-minded approach that has led Virginia to be so successful.

Budget Principles

Before discussing the budget amendments, let me discuss the basic principles we have used in putting our budgets together.

In 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 ever since that time. Prior to October, through amazing work by Cabinet secretaries, agency heads and my finance team, we had already addressed revenue shortfalls of nearly \$1.9 billion. If my proposed amendments are accepted, the total revenue shortfall we have addressed will exceed \$4 billion in the general fund alone.

Our willingness to make difficult decisions promptly has not gone unnoticed. When *Governing Magazine* affirmed Virginia's status as the top-performing state government in America earlier this year, the publication noted that our performance-focused budgeting system was particularly helpful in prioritizing expenditures in a time of limited resources. And, *Standard and Poor's* recently said, "The Commonwealth's strong financial management focus is evident in its early and active response" to the national recession. Thus, 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.

Over the last year and a half, we have found savings in every area of state government – streamlining services, consolidating administrative functions, renegotiating contracts, freezing hiring, layoffs and merging agencies. I have reduced my own salary, cut the executive office budget, left nearly a third of my at-will positions unfilled and been personally engaged in hundreds of hours of discussion and analysis of each programmatic area of state government. And, we have made the tough decisions to keep the budget balanced without any general tax increase and without compromising core services.

In making these hard decisions, my budget team and I follow a set of basic principles.

First, we try to make cuts that position us better for the future, rather than just finding savings for today. Whenever possible, we propose real, long-term savings instead of relying on short-term or one-time actions. Our goal has been to make cuts with the awareness that the economy and our revenue situation will improve. When it does, we want to be able to use new revenue for our most important priorities, rather than just using those revenues to do the same old things in the same old ways.

Second, we avoid a general across-the-board approach in favor of targeted, performance-based cuts. Using the Virginia Performs accountability tool, my team and I have looked closely at each agency, asking hard questions about the priority of each expenditure and seeking data about performance. This approach has enabled us to focus cuts, as much as possible, in areas that do not affect essential services.

Third, we engage in significant discussion of the policy choices that drive our agencies and programs. It is important to understand the factors that drive costs, especially in our big expenditure areas—education, Medicaid, incarceration. You will see that we propose key policy changes in each area so that we can control costs and make sure that our expenditures are truly needed for the public good.

Fourth, we still have to be willing to be innovative and invest new dollars in new areas that promise a return. Some institutions pull their heads into the shell at times of trouble, but that's not what a best managed state does. The distinction is not between new and old programs, but between investments that work and those that have outlived their usefulness.

Education

My full proposal includes reductions in every area of state government, but I would like to discuss a few key areas here today.

The one area that has been held completely harmless in the first 3 rounds of expense cuts has been K-12 education. In fact, as we were cutting most state programs in the biennial budget passed last March, we increased funding for public education by approximately \$1 billion for the biennium in accord with the normal re-benchmarking process. But, the revenue reductions necessary for 2010 are big enough that we cannot ignore the single largest state expenditure in this budget.

I believe it is prudent to allow our public schools to get through the current academic year without disruptive adjustments to their budgets. There will, of course, be the usual technical amendments in the current year for changes in enrollment and the sales tax revenues dedicated to public education. But, for 2010, I propose two adjustments in the way we fund educational activities outside the classroom.

First, I propose an adjustment in how the state funds educational support positions, those local school personnel who are not in the classroom. In the Standards of Quality, we use formulas to cap the state's investment in teachers and other instructional personnel. The most common formula is the student-teacher ratio, i.e., the number of teachers that the state will fund per a certain number of students. This formula varies in different grades, but the basic concept is sound. The state contributes funding for positions up to some maximum and any positions beyond that ratio are funded purely by the local government.

The state has not used a similar methodology to cap funded positions among support personnel. As a result, the growth in state-funded support personnel has been much faster than growth in state-funded instructional personnel. Support positions are very important, but there is no reason that we should not set a reasonable staffing ratio for these positions, just as we currently use for teachers and other instructional personnel. In fact, the absence of any such ratio ensures that the support costs in educational budgets will continue to grow at an escalated rate. That trend will jeopardize needed instructional investments such as efforts to move Virginia teacher salaries nearer the national average.

To save over \$340 million in fiscal year 2010, I propose that we place a funding cap on state spending towards support staff. The state will fund one support position for every 4.03 instructional positions. This ratio represents the 3-year linear weighted average of Virginia school divisions' prevailing practices. Districts that hire more support personnel would do so with local funds, as is currently the case with those jurisdictions that hire more teachers than the prevailing ratio. Along with the cap, I am recommending a loss reduction clause to help mitigate loss of funds for jurisdictions that are most affected during the transition to this new policy.

For additional savings of nearly \$27.5 million, I propose eliminating state general support for school construction grants. I also propose to use \$55 million in Lottery Funds currently directed toward school construction to cover base instructional expenses. This proposal is not meant to downplay the importance of modern facilities for our public schools, but eliminating the modest state contribution to school construction is preferable to eliminating classroom funding.

In higher education, our October actions reduced schools' 2009 base budgets by 5 to 7%. For 2010, I have increased the reductions to 15% for all schools, except the community colleges and Richard Bland, which will have the reduction level increased to 10%.

My introduced budget includes nearly \$26 million in additional money for need-based financial aid. This money will bring every institution up to at least 65 percent of the target financial aid level that has been recommended by SCHEV. My introduced budget also includes increases in the Community College Transfer Grant program, helping more students begin their higher educations at a two-year college and then transfer to a four-year institution to get their degree at a lower cost to their families.

Health Care

Next to education, we spend more on health care than anything else in the budget. Virginia's Medicaid program is very lean. Forty-seven other states spend more per capita on Medicaid than we do. But our current costs are now projected to rise above the previously budgeted forecast by \$268 million, even as our overall state revenues decline. The challenge is made even greater by the fact that tough economic times mean that we can continue to expect Virginians to rely more heavily on these health care services.

In recognition of the hardship Virginians are facing, my introduced budget limits the reductions in Medicaid direct services as much as possible. Some services will now have caps, which will limit enrollment growth but not displace persons currently being served. Most provider reimbursement rates have been frozen or even reduced. Other planned new services will be delayed. Together, my proposed actions will save a total of \$418 million in Medicaid.

When I stood before you in August, I pledged that I would not meet our budget shortfall through a general tax increase on Virginia's families. The budget I present to you today is true to that pledge – there are no proposed increases in sales or income taxes that would further strain families who are struggling to make ends meet.

However, I do propose one tax increase. In order to avoid even deeper cuts to our lean Medicaid program, cuts that would mean denying health care services to low-income Virginians who are currently covered by Medicaid, I propose a 30-cent-per-pack increase to our cigarette tax. This will bring tobacco products closer to paying for the costs that they create for Virginia taxpayers.

The Centers for Disease Control and Prevention estimate that cigarette smoking causes over \$400 million per year in Medicaid expenses for Virginia. This figure doesn't include other non-Medicaid costs borne by Virginia taxpayers for smoking-related illnesses.

Virginia's current cigarette tax only raises \$167 million per year to cover these Medicaid costs. In other words, Virginians have to pay another \$233 million a year in taxes just to support Medicaid costs related to smoking. I believe that the taxes on smoking should pay for the budget costs incurred because of smoking. If we increase the tax by 30 cents a pack, we will generate another \$148 million for the Health Care Fund, which supports Medicaid. This still will not fully cover smoking's costs, but the taxpayer subsidy will be significantly reduced.

A 30-cent increase in the tobacco tax will still leave Virginia's cigarette tax at about half the national average. The increase need not stretch Virginia families, as it is targeted to a specific, non-essential product. And it may, in fact, reduce our health care costs by encouraging some smokers to quit. That, in and of itself, would be a very good thing.

In the area of mental health care and services to intellectually disabled individuals, I've attempted to preserve care for our most vulnerable citizens. In the wake of the Virginia Tech tragedy, we made significant investments last session in community-based mental health care. My proposed budget recommends no cuts in those community programs, except for some administrative savings within the community service boards that would match similar administrative efficiencies required of state agencies.

In fact, my budget recommendations are designed to further our mutual, long-term goal of increasing community investments while reducing dependence upon institutional care. I am proposing to close one of the state's five large training centers for intellectually disabled individuals, close the last state-operated mental health hospital for children, and restructure other state facilities. Community and private providers are actively serving these populations, and I propose to reinvest \$47.6 million from the closure of institutions to expand community care options. And let me assure you, no individual currently residing in these closed facilities will be discharged without an appropriate plan of care and full funding to receive that care in a more appropriate setting.

Finally, our budget protects the advances we made in this biennial budget in funding our health care safety net. The increase in funding to our network of free clinics and community health centers is not cut. And, given our continued challenges with infant mortality, I propose to continue the expansion of prenatal care to more low-income women in 2010, as you approved last year during our biennial budget deliberations.

Public Safety

In past budget reductions, we have done all we could to limit cuts to public safety. In October, I announced that we had planned closures of state Department of Corrections facilities, including many older or smaller facilities. This strategy will help us rely on newer and better maintained facilities instead of spending scarce capital and operations dollars on inefficient buildings. The closures also allow us to address another fundamental question: why does Virginia have an incarceration rate that far outpaces the national average?

Our incarceration rate produces regular and predictable controversies over prison and local jail overcrowding. The rate of growth in the state's budget for incarceration has dramatically outpaced other spending items over the past decade. While we must not make changes that would compromise public safety, we should examine the policy choices that have created such a significant disparity in our incarceration rates.

To begin addressing this issue, my introduced budget includes an adjustment to sentencing policy that will protect public safety while reducing the cost of supporting state and local correctional operations. Current law allows the DOC director the flexibility to release inmates up 30 days prior to the end of their period of confinement. I propose a change that would allow the director to release inmates convicted of non-violent crimes up to 90 days before the end of their term if his behavior warrants it. This small change will result in significant budget savings and less overcrowding in state prisons and local jails without compromising public safety. In addition, we will propose other measures that will help slow the growth of the DOC population by reducing the vast numbers of "technical violators" who are imprisoned every year not for committing crimes, but for violating a technical condition of their parole.

We could not hold public safety officers completely exempt from reductions, but because our front-line law enforcement officers are so important to keeping our communities safe, I have tried to keep the reduction low. My proposed budget limits the reductions for sheriffs' deputies' and Commonwealth's attorneys' offices, state police and local police through the HB 599 program to approximately 7 percent, about half of the cut to most agencies across state government.

Transportation

As you know, the transportation budget is mostly non-general fund revenue, and those sources are suffering from the downturn in the economy, as well. Accordingly, my introduced budget reflects changes in the revenue forecast for transportation. During the biennium, we expect transportation revenues to fall \$600 million from the figures contained in the biennial budget we passed in March. Spread over the full 6-year plan horizon, combined state and federal revenues are expected to fall by \$2.6 billion. I am pleased to report that the President-elect is committed to investing immediately in the nation's infrastructure, and I believe that effort will produce fruit for Virginia.

I have instructed transportation agencies to carefully prioritize their expenditures to maximize our use of federal revenue, protect core safety, maintain rail and public transit and continue innovative private financing efforts. As you know, our primary, secondary and urban road spending will continue to suffer in the absence of a meaningful state commitment to sustained funding.

And, in order to balance its budget, VDOT will reduce central office staff and streamline operations around the state to respond to the reduced revenue forecast. Over the next two years, VDOT is expected to reduce agency employment by about 1,000 employees, through retirements, attrition, and other restructuring. Approximately 1/3 of these reductions will occur in the central office, and the remaining 2/3 will occur in district offices, local residencies and repair facilities around the Commonwealth.

Revenue Policies

In our review, my budget team and I also looked at revenue policies. Land preservation remains a top priority of my administration and we are well on the way toward my goal of permanently protecting 400,000 acres of land during my tenure. However, in these economic times, every program must be on the table. I propose to keep the annual total credit as is, but to make an adjustment in how much of the credit an individual taxpayer may claim in any tax year. By reducing the annual credit maximum for a taxpayer from \$100,000 to \$50,000 we can save \$50 million. I will propose extending the period during which an individual can claim those credits.

Virginia is one of a shrinking number of states that still allows retailers to keep a portion of the sales taxes that they collect. We do not pay the collectors of other taxes like payroll and income taxes. Modern cash registers and computerized accounting systems have made this "dealer discount" an unnecessary diversion of tax dollars. Ending the practice will ensure that \$64.3 million in taxes paid by consumers during sales transactions will actually be remitted to the state and used to support state services.

Investments

In addition to increasing funding to financial aid programs to keep college more affordable, I am recommending a modest investment in our economic development efforts to stimulate growth. Balancing the budget while meeting the needs of Virginia's citizens in the long run depends on growing the Virginia economy.

The introduced budget takes lesser reductions in economic development agencies and programs than from other agencies in government. It also calls for a \$5 million increase in the Governor's Opportunity Fund, the Commonwealth's primary job-creation incentive fund. I have also 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.

My budget also includes a \$1 million grant to the Virginia Federation of Food Banks. We have eliminated nearly all of the non-state agency spending from the budget, but this particular expenditure is very important. There are few needs as critical as food for the hungry. As the economy has worsened, food banks across the Commonwealth have seen donations decline and their shelves depleted, even as more Virginians have found themselves in need of this vital assistance. I hope you will support this needed safety net service.

The budget also protects tools that help improve the efficient delivery of government services, like the Productivity Improvement Fund (PIF). To date, the \$3.4 million investment from the fund across 28 projects will deliver nearly \$10 million in savings over three years, for a 3 to 1 return on investment. From our successful Business One-Stop web portal, to major reengineering of agency work processes in the Department of Motor Vehicles, these productivity investments are part of a growing culture of continuous improvement. We must keep innovating, and we will.

Finally, unlike past efforts to balance the state's budget during recessionary times, I have not put a freeze on general fund capital outlay projects. The continuation of our capital program (especially the capital projects included in the package we enacted last spring) will help us deliver essential services to our citizens at the same time we provide much needed stimulus for the economy. And, in a time of slack demand, construction pricing is favorable and we will get moving on needed projects to take advantage of that fact.

State Employees

Finally, I want to acknowledge that, in all these difficult times, our state employees continue to serve with distinction. I announced in October that I was putting off a proposed employee salary increase scheduled to be implemented in November. I had hoped to begin that salary increase in July, but the tough budget and uncertainty ahead compels me to eliminate the proposed salary increase in this biennial budget. This is not the news I hoped to deliver, but the alternatives—deeper layoffs or more service cuts—were just not acceptable.

I feel deeply for those public employees who work hard every day and find their salaries flat since the 4% raise in November 2007. And, I feel even more deeply for dedicated public employees who will no longer be employed because of slowing revenues. These are truly difficult times.

Conclusion

While there are many challenges ahead of us, we can look forward with hope. Even in this atmosphere, our excellent schools, colleges and universities produce the ideas and graduates that will keep driving our economy. The advances we have made in career and technical education and our restructuring of workforce efforts under the community college system enable us to better prepare our dedicated workforce. Our international connections through the Port of Virginia and Dulles Airport give us a unique ability to be a leader in global commerce. These strengths and many others of our beloved Commonwealth continue to be our ticket to a prosperous future.

We are well positioned to come out of this recession quicker and better than many other states. Our fellow Virginians will thrive in a refreshed economy that will be built on new technologies, green jobs and global trade. Our state government will also be leaner and better equipped to make the most productive use of our tax dollars possible.

And it's not just about the tools we have. It's also about character. Adversity reveals character. Our citizens will be watching us this session to see how their leaders handle things. They expect problem-solvers, innovators and visionaries. If we act in a mature and sensible way, making decisions that are smart and farsighted, working together for the common good, we can be part of the effort needed in this nation to begin a lift in public confidence.

I am confident that better days are ahead for our Commonwealth and Country. We have always faced adversity and successfully mastered it. We need to hold fast to the basic things—love of family and friends, commitment to work, learning and sacrifice, faith in power greater than ourselves and the willingness to work together. This is the Virginia that we all know and love.

I wish each of you a blessed holiday."

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