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
Richmond
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FOR PUBLIC RELEASE

Thank you.

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

Welcome back to Richmond for the continuation of the never-ending 2011 legislative session.

As is the custom each summer, I come to provide you a summary of the recently concluded fiscal year, and to offer some thoughts on both the challenges and opportunities that lie ahead.

First, the bottom line: I am pleased today to announce that the Commonwealth finished FY 2011 with a total budget surplus of $544.8 million. This is composed of a $310.7 million revenue surplus which I announced last month, $170.5 million in savings from unexpended general fund appropriations, and $63.6 million in unexpended non-general funds that must be reported on the balance sheet due to accounting standards.

In the midst of a difficult economy and global financial unrest, a budget surplus of over half a billion dollars is a notable accomplishment. This is the result of bipartisan cooperation here in Richmond, where we have toned down the rhetoric, and made the tough decisions through conservative budgeting and fiscal discipline. Thank you for your work together to make this happen.

We are all aware of the economic uncertainty that surrounds us.

Last week was the wildest 5-day period in the stock market since October 1987. As of Monday, the Dow was down 6% in three weeks. This has been excruciating for many middle-class families watching their retirement accounts and college funds. The value of Virginia Retirement System investments declined by $3.2 billion from June 30 to August 12.

The national unemployment rate remains above 9% for the fourth straight month.

The University of Michigan Consumer Sentiment Index, which is one of the top measurements of national consumer confidence, fell to its lowest level in over 30 years.

At the same time, the American people have little confidence in the basic ability of national leaders to get anything done. A recent *CNN* poll found disapproval of Congress at 84%, the highest number since 1992. A *National Journal* poll released August 3rd reported, “When it comes to important problems facing the country, only 7 percent of respondents said they have a lot of confidence that Washington could make progress over the next year." Facts such as these mean that most of the important work to solve problems and create opportunities will rest with us here in the states.

We have the opportunity to continue to demonstrate that Republicans and Democrats and Independents can govern well together to get things done, as seen in our passage of a unanimous budget this year. Exercising fiscal restraint will produce positive results.

This is the second time that I have appeared before you to review the year-end financial position of the Commonwealth. In these two years, I have announced revenue surpluses and budget savings of nearly $950 million. That's not bad for any state in this economy.

Simply put: Over the past 2 years we have brought in more revenue than forecasted, and spent less than budgeted.

I'm encouraged to report to you that the Commonwealth's general fund revenues have returned to a pattern of growth, and our financial position continues to improve.

For fiscal year 2011, total general fund collections, including revenues and transfers, exceeded the official forecast by $310.7 million. General fund revenues rose 5.8 percent in FY 2011 compared with the budget forecast of 3.5 percent. In the enacted budget, general fund revenues were estimated to grow by 6.0% in FY2012 over FY2011. With this current revenue surplus, revenues now have to grow only another 3.7% to meet the budgeted revenue figure for FY2012. That is good news. Also, while total revenues have not yet returned to fiscal year 2007 levels, it is important to note that this is the first year-over-year increase in general fund revenue collections since FY 2008.

Four out of every five dollars of the revenue surplus came from income taxes, either personal or corporate. Corporate and non-withholding taxes account for $165.9 million of the general fund revenue surplus. Payroll withholding and sales tax collections, which account for nearly 85 percent of total general fund revenues, exceeded the forecast by $103.8 million. Virginians are doing somewhat better, and the result is a revenue surplus. Moreover, 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 6% today.

The fiscal year 2011 revenue surplus is also attributable to reliable fiscal advice, which drove Virginia's consensus revenue forecast process. In the fall of 2010, based on candid analysis from economists, business leaders, and General Assembly members received through GACRE and JABE, the outlook for fiscal year 2011 was adjusted slightly downward in anticipation of slower employment growth. This conservative revenue forecast was crucial to our ability to budget responsibly in a complicated environment. While we did bump up the estimates slightly during the session, your prudent fiscal restraint enhanced the fiscal year 2011 surplus.

Our administration continues to focus on reform, productivity and efficiency. We directed our managers to innovate, be frugal, and not spend all their appropriations at the end of the fiscal year just because they had the money. Thus, on the savings side, there was $234.1 million in unspent appropriations at the end of June. This compares favorably to the $174.7 million that I reported as the savings at the end of fiscal year 2010. Together we are proving that, unlike Washington, we can actually spend less and deliver good customer service for our people.

Of the $234.1 million, $63.6 million in balances come from certain non-general fund accounts that are required to be reported on the general fund balance sheet at the end of the year. Approximately $49.2 million of this amount consists of balances in higher education operating funds that are brought forward pursuant to mandatory language as specified in the Appropriation Act. The remainder, or $170.5 million, constitutes real operating savings from unspent general fund appropriations. Concrete measures that have contributed to the overall savings achieved include a continuing hiring freeze, incentives to promote individual employee savings ideas as well as better agency performance, and the reorganization of both management and operations within many state agencies. 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 this year.

We also have positive news to share regarding the Commonwealth's liquidity. During the three-year span (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 two years, this trend has been reversed. Virginia's available cash reserves have risen 30 percent from $2.3 billion on June 30, 2009, to $2.9 billion on June 30, 2011. 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.

I do want to address a few misunderstandings I have heard about Virginia's back-to-back surpluses. We can and must have legitimate debates about spending priorities and future budget needs, but this surplus is a simple matter of math, not politics. When revenues exceed the forecast, and spending is less than budgeted, basic math indicates a budget surplus. We should celebrate our budget work together. It is making Virginia stronger than most states as we recover from the recession.

I want to briefly clarify the budgeting impact of two recent budget actions: the deferred contributions to the retirement system and the accelerated sales tax program.

The deferral of retirement contributions in 2010 helped address the $4.2 billion budget shortfall that existed before the budget was enacted, but it had nothing to do with the surplus that came after the fact. It reduced spending in the budget by temporarily reducing contributions to VRS. Thus, it did not affect general fund revenue collections and played no role in the $310.7 million revenue surplus. We are repaying the VRS deferral at an accelerated rate, with interest, and thus it has no impact on the long term health of the VRS. In fact, increased state contributions will begin in the fourth quarter of FY2012, one quarter earlier than initially planned, since you approved my amendment during the reconvened session.

In 2009, the General Assembly passed the policy known as the accelerated sales tax. It is a policy that I have called for eliminating as quickly as possible, and you approved my recommendation to move the beginning of the phase out from 2015 to 2013. Some have stated that this policy is partly responsible for this year's surplus. That is absolutely incorrect. The accelerated sales tax was a one-time event that affected only FY 2010. While FY 2010 did have 13 full months of sales tax revenue, this year did not. Thus, there is no extra month of sales tax revenue in this surplus for FY 2011. In fact, we even took steps this session to reduce the acceleration by $47 million in FY 2011, which means we actually had less than 12 full months of sales tax revenue in this past fiscal year, but still generated a $310.7 million revenue surplus .

The important question now regarding the surplus is where will this money go, and what does it mean for the FY 2012 budget and beyond? Over the past few weeks, I have reviewed the Commonwealth's fiscal situation in detail with Secretary Brown and my finance team. After taking into account the budgetary and statutory requirements for re-appropriation and other factors, the net additional resources available for further budgetary action equals $383.4 million. This amount is composed of the $310.7 million revenue surplus and $72.7 million in unspent general fund appropriations that I have tentatively slated for reversion to the General Fund. I appreciate the fact that this past session you approved my proposals to significantly reduce mandatory reappropriations of balances to agencies, which gives more incentive and flexibility in controlling costs.

The Constitution, Appropriation Act and Code have a number of provisions which specify how most of these additional resources must be assigned. Principally, $132.7 million must be set aside for deposit to the Revenue Stabilization Fund, raising the Rainy Day Fund balance to $440.5 million in FY 2013, the highest balance since FY 2009. Another $50.3 million is designated for deposit to the Virginia Water Quality Fund. These two actions will help us improve liquidity to guard against any future shortfall in budgeted revenues, and help us meet our obligations under the Watershed Improvement Plan to accelerate our efforts to clean up the Chesapeake Bay.

In addition, we will be able to meet several other contingent requirements in the Appropriations Act. We will allocate $8.9 million to the federal government for interest on the Unemployment Compensation Trust Fund, $7.5 million for our efforts to curtail encroachment around the Oceana Naval Air Base pursuant to BRAC parameters, $7.4 million in supplemental funding for sheriff's offices, and $26.0 million to return to transportation for its share of the accelerated sales tax payments collected in June.

Also, as required by the significant transportation legislation in 2007, $67.2 million, or two-thirds of the unappropriated surplus balance, will go to the Transportation Trust.

Finally, another $18.7 million will go to the Nonrecurring Expenditure Fund. I plan to use a portion of that revenue to supplement contributions to the Virginia Retirement System as we work to ensure the solvency and viability of the system.

As I noted at the beginning of my remarks, we meet today in a fiscal climate marked by volatility. Much uncertainty emanates from our nation's capitol. We all know that there is a very close financial and economic relationship between the Commonwealth and our federal government. That relationship has come under greater scrutiny in light of recent actions by the major bond rating firms. But that relationship is much more complicated than some would suggest.

In 2009, Virginia ranked 2nd among the states in total per capita federal expenditures. However, our ranking varies significantly when we break the spending down by category. We do not receive a uniform amount of federal dollars across the board.

Also in 2009, Virginia ranked 1st among states in federal spending per capita for procurement, 2nd among states in per capita defense spending, 4th in salaries and wages, and 5th in retirement and disability payments. However, we only ranked 39th nationally in per capita federal spending for direct payments and we ranked second to last, 49th, in per capital federal grant spending.

What this means is that as the budget and debt reduction decisions are made in Washington, it is very hard to predict the exact impact on the Commonwealth. Significant reductions in defense spending and contracting would present big challenges. A spending reduction plan highlighted by entitlement reforms and reductions in grant spending would present far less of a fiscal threat.

Most of us would agree that Washington has borrowed and spent too much for too long, and has failed to come to grips with its long-term deficits and debt in any meaningful way. Both parties contributed to the scope of the current problem over the past decades. We have seen no material progress to enact a coherent, balanced federal budget that prioritizes core duties like national security and makes much needed cuts in discretionary spending while reforming entitlements. As a result, the federal government must significantly reform and retract by necessity. That conversation is playing out currently, and was at a fevered pitch during the weeks preceding the raising of the national debt limit. There may be Super Committee proposals prior to me completing the FY 2013 and 2014 introduced budget this December to avoid the automatic triggers, but that, too, is uncertain.

In the midst of the debt ceiling crisis, Moody's Investors Services placed the United States government on its credit watch by assigning a negative outlook to the U.S. sovereign debt rating. On August 4th, Moody's affirmed the Commonwealth's Aaa bond rating, but unfortunately assigned Virginia a negative outlook due to the nexus of the Commonwealth to the federal government with its significant presence in and impact on the Virginia economy. We were not alone, as four other Aaa states were also watch listed, including our neighbor to the north, Maryland. Moody's has said that over the next ninety days, it will be looking at the ratings of state and local government issuers, including the Commonwealth, to determine if those issuers should stay on negative outlook or be once again assigned a stable outlook.

This week Fitch reaffirmed the United States Aaa rating with a stable outlook, and no impact on Virginia's ratings are anticipated from this firm.

Standard and Poor's downgraded the Federal Government on August 5th. Standard and Poor's has not taken any parallel action against Virginia to date, because it has not directly linked its state and local government ratings to its rating of the US sovereign debt.

Moving forward, Standard and Poor's will examine each state for its interdependence on federal government spending and cash flows for various items such as Medicaid. Standard and Poor's has set up three basic criteria to allow a higher rating for a state or local government than that of the federal government, provided such state or local government demonstrates the following characteristics:

- The ability to maintain stronger credit characteristics than the sovereign in a stress scenario,
- An institutional framework that is predictable and that is likely to limit the risk of negative sovereign intervention, and
- The projected ability to mitigate negative sovereign intervention by a high degree of financial flexibility and independent treasury management.

Since our bond rating challenges relate almost entirely to matters controlled by the federal government, and not of our own making, it is a very difficult situation to manage. Judging from the information we received recently from Moody's and Standard and Poor's, we need to demonstrate to Wall Street that we are a vibrant and well managed state with an economy that is flexible and diverse enough to withstand the potential fiscal stress that federal government cutbacks or inaction may deliver to us.

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 back-to-back budget surpluses send a very positive signal to both firms. Our relatively low unemployment rate does the same. 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.

For this reason, I am recommending that the General Assembly create a reserve fund which will be available to address a variety of potential negative impacts from actions at the federal level to deal with the national deficit and the broken federal budget process. This "Federal Action Contingency Trust" Fund, or FACT Fund, should initially be capitalized with $30 million from the surplus. The "FACT" Fund will provide us added flexibility to deal with those circumstances which would otherwise not be permitted by law by using the Revenue Stabilization Fund. It is another proactive step towards demonstrating to the bond rating firms that Virginia has ample cash reserves and committed to taking all necessary actions to prepare for the necessary and inevitable downsizing of the federal government.

Additionally, in the days ahead I will be issuing an Executive Order to expand the mission of the Jobs Commission, and the role of the associated economic development officers of the Commonwealth. This Order will direct state leaders to examine the best ways to strengthen and diversify economic activity in Virginia in the face of potential federal procurement and defense contractions. This is a critically important long-term goal, but one that must receive immediate emphasis and attention. Lieutenant Governor Bolling will spearhead the Commission's work. It will require the kind of bipartisan public-private effort that has long defined Virginia.

The upcoming financial decisions are not the only challenge we face from our federal government.

While Washington did assist states in the short term with certain Recovery Act funds for education and Medicaid, unfunded mandates continue to pour across the Potomac. Just with mandates in health care reform, mental health demands, and EPA-directed Chesapeake Bay cleanup, Virginia faces over $10 billion in cumulative unfunded mandates alone. That puts our recent surpluses in perspective. Other obligations contained in No Child Left Behind, new EPA regulations, entitlement matches, and other items only add to the cost. Moving forward, we will have to work together to address these mandates and how we will manage them.

There are also other key state obligations and needs that must be addressed. The Board of Education has just recommended that the rebasing of the Standards of Quality and incentive education programs will require approximately $319 million in the next biennium. We all know that the unfunded liabilities in the Virginia Retirement System for state employees and teachers total approximately $18 billion, of which in excess of $7 billion represents liabilities payable by the general fund of the Commonwealth. I will be asking you again to make reforms to the system to ensure its long term health. There are a host of other needs including aid to localities, economic development to foster job creation, higher education, transportation maintenance and public safety that will require some attention over the next several years. When all of these needs are considered, there is no doubt that funding for new programs will be scarce. While our fiscal situation is improving, the Commonwealth still has a lot on its budgetary platter. Thus fiscal restraint, targeted spending cuts and government reform must continue.

The good news is that where Virginia controls its own fate, we are doing well. Over the past two years we have made tough decisions, set priorities, held the line against raising taxes, and reduced state spending to 2006 levels. At the same time, we have invested state dollars wisely on items that will create long term opportunity and prosperity. We have made the greatest investment in transportation in a generation. We have begun to enact policies to make college more affordable and accessible for Virginia students. We have put new resources into economic development.

The results are evident. Two months ago, CNBC named Virginia as America's "Best State for Business." Two days ago, Pollina Corporate did the same. Our unemployment rate, due to a number of factors is three points lower than the national average. It is the third-lowest unemployment rate east of the Mississippi, and the lowest unemployment rate in the Southeastern United States. While comparably low, this rate is still unacceptably high, with over 250,000 of our fellow citizens without work. We must continue strategic investments and policies to spur private sector job creation.

The proper role of government is to provide essential services; invest in the core functions that are crucial to the prosperity and well-being of our families and workers; and then get out of the way and let the free market and private sector create the good jobs our citizens need.

That is the focus of our Administration. We will continue to offer ways to create savings and efficiencies, and invest in things which expand opportunity. You all have been tremendous partners and leaders in this bipartisan effort. Tough spirited negotiations during the most recent budget conference produced a unanimous budget. Our collective work has resulted in back-to-back revenue surpluses and budgetary balances totaling $950 million. Working together, I know we will continue to make this a true "Commonwealth of Opportunity" for all our citizens.

Thank you for your service, sacrifice and faithfulness to our great Commonwealth.