



COMMONWEALTH of VIRGINIA

Office of the Governor

Robert F. McDonnell
Governor

February 17, 2010

The Honorable Charles J. Colgan, Sr.
General Assembly Building
Room 626
Richmond, VA 23219

The Honorable Lacey E. Putney
General Assembly Building
Room 947
Richmond, VA 23219

Dear Senator Colgan and Delegate Putney:

The greatest challenge we face this session is balancing the state budget. During my nineteen years in elected office, we have not faced this many tough fiscal choices. Significant additional spending reductions will be necessary to balance the budget, above the \$2 billion already proposed by Governor Kaine for the next biennium. Thank you for meeting with me several times over the past few weeks to discuss the budget situation and provide you specific recommendations.

I have chosen the process of collaboration over dictation in helping you work on the introduced budget you have had since December 18. Our meetings and those of Secretary Ric Brown with you, your key staff, and other members have been productive. Today, I am also releasing the revised mid-session reforecast of general fund revenues as part of our ongoing dialogue to assist you in your final budget preparations.

It is absolutely essential for the good of all Virginians that we work together to pass an acceptable budget as required by March 13. Continued frank discussion will be necessary to enact a final budget. To this end, I will continue to make available all of the budgetary and policy resources within the Executive Branch to help you, as you see the need, during your deliberations.

In my review of the amendments during the last several decades offered by governors in their first days in office, I have found that such amendments normally change the introduced budget at the margin for technical or limited policy reasons. They did not attempt to re-write the budget in principle. The \$2.2 billion budget gap contained in the introduced budget is an historic amount. It is more than five times the \$400 million in biennial budget amendments offered by Governor Warner when he came into office in

2002, the previous largest adjustment according to Department of Planning and Budget records.

As we set out to adjust the budget to this reality, I have outlined certain priorities for you. First, my primary budget and legislative focus throughout this General Assembly session is to enhance the Commonwealth's economic development and job creation tools. The need to create more jobs is the one common theme that I hear from our citizens in every part of the Commonwealth. Accordingly, I thank the Chairmen of the money committees for patroning the \$50 million in biennial budget amendments that I sent down for this purpose. I also appreciate and thank the General Assembly for the warm reception these proposals have received.

My second priority is to ensure that our budget development efforts are conducted in the manner consistent with our collective desire to maintain our Triple A bond rating. We all share in the accomplishment of being one of only seven states with the Triple A rating from all three major bond rating firms. Maintaining this distinction is critical to our economic development efforts as well as our efforts to stimulate jobs through future capital projects.

Third, the budget must ultimately maintain as much funding as possible for core services. However, we must recognize that larger reductions will need to occur in those areas not previously subject to significant spending cuts. Large cuts over the past two years have already been made to higher education and public safety, so these areas should be largely protected.

Finally, an acceptable final budget must be done on time, and contain no general tax increase on the families of Virginia. Tax increases only serve to potentially dampen the economic recovery in Virginia, and allocate scarce resources away from our citizenry at a time they can least afford it. The House of Delegates has already unanimously defeated a \$2 billion income tax increase. As difficult as this budget process will be, I am confident we can reduce spending through targeted and innovative strategies. As I stated in my first speech to the General Assembly last month, I will not approve any legislation or budget language that increases taxes on the citizens.

Over the past weeks since taking office, I have devoted a great deal of time reviewing the introduced budget to prepare suggestions to help you fulfill your duty to craft and pass a balanced budget. As previously communicated to you and your staff, outlined below is a framework for spending and savings actions to improve the introduced budget and address this historic \$2.2 billion shortfall. Additionally, I am including in this letter the last piece of the budgetary framework; the revised mid-session reforecast of general fund revenues. Each component within the framework is discussed below.

Spending Recommendations

Ensuring the safety of our citizens is the top responsibility of government. Consequently, several proposed reductions in the introduced budget affecting law enforcement officers on the street must be reversed. I recommend restoring at least \$60 million over the biennium for sheriff and police officer staffing and state police trooper academies. We must maintain the ability of our first responders to meet service demands in a timely and safe manner, particularly in this tough economy when crime may increase.

I also am recommending two important education funding adjustments to the introduced budget. First, we should implement the Local Composite Index (LCI) adjustment in the first year of the biennium as has been done routinely for nearly four decades. Obviously, every biennial update shifts the percentages for each locality and there are winners and losers. Nonetheless, fairness dictates that we not change the longstanding policy of making the routine technical adjustments to the formula that apportions education funds solely for the short term gain or political reasons.

Second, I ask that we restore funding for the School Technology Program. This is a top priority for our state school superintendents, and will allow us to leverage scarce state resources for instruction. An investment of only \$13.5 million will permit us to issue \$110 million in technology bonds over the biennium for computers and technology equipment in the classrooms.

Third, I propose that we restore state funding for the full 5% employee contribution to the Virginia Retirement System (VRS). As you know, the state began paying the employees 5% contribution in 1983, in place of a salary increase. As a result, our current employees correctly understand this is part of their state salary. Our dedicated state employees have not received a salary increase in almost three years, and have continued to meet the demands of our citizens even as their agencies' budgets were being significantly reduced. Restoring this proposed reduction honors their hard work and the spirit of the state's 1983 compensation agreement. In addition, to show the value we place in our talented workforce, I propose that state employees be given a 3% bonus in December 2011. A similar step was last taken in late 2003.

Finally, the approved budget must provide \$950 million each year for personal property tax (car tax) relief. As I stated previously, now is not the time to increase the tax burden on our citizens. Moreover, I believe that Virginians will use this tax relief to boost our economy through the purchase of needed goods and services, help finance college educations, or to save the money which will flow through to investments in businesses and ultimately result in more job creation opportunities.

Proposed Spending Reductions

As noted earlier, there is no way to close a \$2.2 billion budget shortfall without significant reductions to certain service areas of the budget traditionally spared cuts. While this will be a very difficult stretch for many Virginians, state agencies, and local governments, it is a time that calls for sacrifice, creative management, and innovation. I call on all our leaders and stakeholders to work together to find ways to lessen the hardships, as we slowly rebound from this devastating economic downturn.

According to the recent JLARC report, overall spending in Virginia increased 73% over the past decade, 28% faster than the rate of growth in population and inflation. Direct aid to K-12 education funding has increased by 55% during that time to \$6.2 billion in FY2009. Education generally, has accounted for 39% of total budget growth over the past decade. In the past five fiscal years alone, K-12 general fund spending has grown 38.4% larger than any other major budget segment. While much good came from these investments, such significant growth indicates that this is an area for reduction during this very tough budget cycle.

In the area of public education, reductions of about \$731 million (or 11% over the biennium) will be necessary. (see attached) However, all but \$200 million of these reductions can be offset from local savings in VRS that I will discuss later.

Primary and secondary education (K-12) funding was only reduced 2% in FY2012 in the introduced budget, while higher education and public safety were cut 14% or more. These required reductions in public education will put K-12 educational funding back at the same level it was in 2006, and consistent with our general fund revenue reductions. I recommend focusing reductions to the maximum extent practicable in non-instructional spending. We have provided specific savings strategies to you and your staffs to accomplish this goal.

Understandably, this will create a short term hardship on our great teachers and school administrators. Restoring education funding will be a top priority as the budget situation improves. I also remain hopeful we will get help later this year from our \$350 million federal Race to the Top grant application submitted by Governor Kaine last month for charter schools and merit pay. In addition, I believe that our excellent public school administrators will use creative management and instructional techniques to meet the needs of every student who enters their schools.

In addition, state funding for various health and human resources programs will face reductions of approximately \$316 million. (see attached) Reductions in funding of over 10% for various programs and a closure of certain institutional beds will be required. This reduction cuts into the introduced budget's growth in health and human resources, but the FY2012 appropriation will still be the largest ever for this functional area. As you know, appropriations from the general fund for health and human resources have grown

64% over the past decade. I remain committed to finding more efficient ways and more effective programs and services that will meet the demands of our most vulnerable citizens.

In the area of employee compensation, I also propose capturing significant savings from reduced state contributions to VRS. I propose these changes, which will be largely transparent to employees, to reduce VRS payments by about \$786 million over the biennium. These changes will generate savings at the local government level in excess of \$500 million that can be used to help local governments offset the state cuts in K-12 education (see attached).

I also recommend considering savings of \$180 million by requiring up to five days unpaid leave for certain state employees each year for the next two years. While this is not easy to recommend, it is consistent with what is being requested in pay cuts from the managers in the Executive Branch, and warranted given the necessary reductions to core service areas. Moreover, it is not a reduction strategy anticipated to last past the 2010-12 biennium.

Finally, I recommend we capture the savings of \$100 million in aid to localities resulting from eliminating the car tax relief roll back in the introduced budget bill. Moreover, I recommend that we not make the \$40 million advance deposit in the rainy day fund in 2012. We will make the rainy day fund deposits as required in fiscal years 2013 and 2014.

Mid-Session Reforecast of Revenue

With January behind us, we now have actual revenue collection data for the first seven months of this fiscal year. The Department of Taxation has carefully looked at this data and the underlying economic variables to assess if any change in the general fund revenue estimates for the remainder of this fiscal year and the next biennium are warranted. This examination constitutes the mid-session review of the revenue estimates which normally occurs each year at this time. (see attached)

Yesterday, the Department of Taxation reported to me that, conservatively, the official revenue estimate for this fiscal year could be increased by \$103.5 million including the \$21.0 million in additional revenue already received from the Tax Amnesty Program last December. Much of this increase is caused by individual and corporate income tax refunds trending lower than originally assumed. Together, the assessment of where we are in terms of this refund activity suggests that we could add \$80.5 million this year to the revenue estimate by lowering the level of refunds to reflect actual year to date trends.

Another \$15.0 million in the reforecast comes from recordation tax receipts. Recordation tax collections through January have declined about 1.1 percent from last

year versus the official forecast in the introduced budget which assumed a 9.6 percent decline for the year. The increase in this source is almost entirely offset by increased refund activity involving premiums taxes paid by insurance companies which are trending \$13.0 million above the official forecast.

Net of the additional Amnesty Program revenue (+\$21.0 million) already reported to you, these changes would add \$82.5 million in revenue available for appropriation this fiscal year. Adjustments in each year of the next biennium to reflect the ongoing impact of these changes would add \$63.9 million to FY2011 and \$54.1 million to FY2012 or \$118.0 in new general fund resources for the next biennium. The three year total of net new revenue available for appropriation (excluding Amnesty) would be \$200.5 million. This amount would almost be enough to mitigate all of the proposed reductions for K-12 education or be used for other core services.

Summary

The changes outlined above, and other ones, provide a range of options for generating the \$2.2 billion in savings necessary to balance the budget. There are numerous alternative strategies attached to make the targeted reductions to K-12 education and health and human resources outlined above. You have indicated to me that you have other ideas as well to cut spending which I applaud. As I have already done on several occasions over the past several weeks, my staff and I will continue to meet with you, your subcommittee chairs, and your committee staff to exchange ideas and provide information for making these difficult cuts in the most effective manner. Secretary Ric Brown has already had additional meetings to accomplish that goal. Please be assured of my personal involvement to assist you in the conference committee process.

The framework that I have laid out in this letter requires tough decision-making. I recognize that these cuts will have a measurable impact on our people. But as families and businesses cut and struggle through the economic downturn, so too must state government. The net additional resources of \$200.5 million resulting from the mid-session reforecast of general fund revenues should make a few of these choices less difficult.

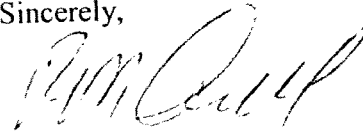
Recognizing that state government must be quickly transformed to align it with our current budgetary and revenue situation, on Inauguration Day I signed Executive Order #2 to begin the process of reforming state government. I intend to make numerous changes and recommendations to you later this year to reorganize state government and better control state spending. I hope to have some of these savings strategies identified by mid-year to help soften the impact of other proposed cuts in the budget.

As public servants, we have all taken an oath to fulfill our duties to the best of our abilities. The duty before us is to balance the state budget on time and invest in economic prosperity for tomorrow, without placing additional tax burdens on the people we

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represent. I know that if we work together in a cooperative fashion, we will achieve the foregoing objectives on behalf of the people of the Commonwealth. I stand ready to work with you towards enacting a budget consistent with the above principles.

Sincerely,

A handwritten signature in black ink, appearing to read "R. McDonnell", written in a cursive style.

Robert F. McDonnell

RFM/pdw
Attachment
cc: Budget Conferees
General Assembly Leadership