BUDGET ADDRESS OF GOVERNOR DENNIS DAUGAARD

THE STATE CAPITOL – PIERRE, SOUTH DAKOTA – DECEMBER 3, 2013

Thank you and welcome. It's good to be here with you, and I am very pleased that so many of you came in spite of the snowy weather and the slippery roads. Thank you very much for being here. Today, of course, I am here to offer my budget proposal for FY15.

Before I do that, I'd like to recognize a few people. With us today are three legislators who will be joining us here in Pierre for the coming session. Those of you, as I call your name, please stand and please help me welcome Senator Blake Curd, Representative Dave Anderson, and Representative Kris Langer.

In today's remarks, I am going to be updating you on the state's economy, reviewing our revenues and expenses for the current year, and offering my proposals for the next year.

To begin, I want to talk about how this budget came together over the past couple of months. Until recently, the landscape was not very promising. On June 30, at the end of FY13, despite ending with a $24 million nominal surplus, our ongoing revenue in FY13 was $4.5 million below the adopted estimates, so our revenue base was lower before FY14, our current year, even began. Because our revenue base was lower, preliminary revisions for the current year we are in now were about $6 million short of what the adopted estimates were. In September, things didn't look very good.

Our initial FY15 estimates in September projected increased revenue of $41.4 million. That's in the blue. However, to fund just minimum increases in the largest expense categories, we would need $62.9 million. That's the red bar. Those budget categories included an inflationary increase of 1.6 percent for K-12 education, an FMAP change of 2.08 percent for Medicaid, provider inflation at 1.6 percent plus mandatory provider inflation, entitlement eligibles growth, that is eligibles for Medicaid, CHIP, and also utilization growth by those entitled and enrolled, State Health Insurance costs, an inflationary increase for state employees of 1.6 percent, and a transfer from general funds to Building South Dakota's fund.

This $62.9 million did not include anything for the Board of Regents, nothing for the Tech Schools, nothing for the other executive departments, nothing for maintenance and repair increases. That was just for the 1.6 percent, so things didn't look very good.

Fortunately, the situation has changed since September, and of course, the most significant change was in the unclaimed property that was received just last month. As you look at it, unclaimed property has been very unpredictable over the past several years. In FY14, we projected an increase for two reasons.

One, you might remember in recent years several banks have relocated their home offices into South Dakota because of our positive regulatory climate. That increased the unclaimed property that became part of South Dakota's unclaimed property.

Second, in 2012, I proposed and you passed HB 1270, which shortened the time period after which unclaimed property is presumed to be abandoned. It used to be five years. I proposed and you shortened it to three years.

These two actions increased our unclaimed property receipts, and we knew they would jump because of 5-year, and 4-year, and 3-year property all coming in this year in FY14. They increased our unclaimed property receipts to over $30 million in FY13 and our projections in FY14 were over $50 million. For FY15, we originally projected about $34 million in ongoing unclaimed property, the far right bar.

Even after projecting these increases, unclaimed property changed significantly in the last month. The November 1 annual unclaimed property transfers exceeded $125 million. Two banks alone submitted $122 million in unclaimed property.

This chart shows the actual receipts of $122 million, after you net out projected refund claims of about $3 million. $122 million is the net. Working with the Treasurer's office, we believe $67.5 million of the $122 million figure will be repeated next year in FY15. So, you see the total of $67.5 million on the far right bar as the new ongoing estimate of unclaimed property.

As we worked to craft this year's budget, this single development dramatically affected both ongoing and on-time revenue projections. Let me tell you how I have worked these changes into my proposed budget.

First, I want to discuss the ongoing increase. We jumped the ongoing increase when we received the property in FY14. For FY15, we increased it by $33.5 million. The difference between the original FY15 estimate of $34 million and today's estimate of $67.5 million is that difference of $33.5 million.

Remember a minute ago I said we were about $20 million short of even providing a 1.6 percent minimal inflationary increase and other normal expenses. The ongoing unclaimed property revenue now is enough to fund that minimal level, and to provide funding for the Regents and the Technical Institutes.

It gets us to 1.6 percent. It's not enough to increase funding by much more than that, however, unless we take some other steps. To do that, I looked to the one-time money we have available.

We all know there are plenty of good uses for one-time money. I've proposed them before; some of you have proposed them before. Although schools, providers, and other recipients of state funds appreciate one-time money, they very much prefer ongoing dollars. I've heard this many times, and I'm sure you've heard it too. They want to build reliable ongoing resources into their base budget.

So this year, I propose we use one-time money to free up ongoing money. I am proposing two approaches to do that. This will free up over $23 million in ongoing dollars for our FY15 ongoing budget.

Let's take a look.

First, I propose using $30 million of one-time money to pre-fund the Building South Dakota program created by SB235 last session. If you recall, SB235 requires 25 percent of the unclaimed property receipts in FY15 and 50 percent of the unclaimed property receipts in every year thereafter to be deposited into the Building South Dakota fund. If, instead, we pre-fund this program now, we protect it from future fluctuations in unclaimed property. We also guarantee this funding will be available over the next several years, and it will not compete for ongoing dollars with schools and providers during that time.

Pre-funding Building South Dakota this year frees up $16.9 million in ongoing money. Here's how that increases ongoing revenue.

Remember our initial FY15 revenue growth estimate was $41.4 million. To that we'll add $3.8 million in revised revenue growth projections. Next we add revised revenue from the unclaimed property, remember that was $33.5 million more. We would under present law subtract $16.9 million under the current law as a tax expenditure for SB 235 for the Building South Dakota program. The net total ongoing revenue growth would be $61.8 million. That's the level at which we can afford just 1.6 percent increase. However, if we pre-fund the Building South Dakota program with one-time dollars, we can eliminate that tax expenditure. Our projected ongoing revenue growth improves by $16.9 million to a total of $78.7 million in ongoing revenue growth in FY15. Remember this $78.7 million number, you'll see it again.

Let's look more closely at the proposal to pre-fund Building South Dakota. When Building South Dakota was established, it was projected to receive $7.3 million in FY15, and if you look at the bottom of the first dollar column, $36.4 million over the first three years. That was the projection. However, these were ongoing funds. The law included a trigger that suspends the transfer and the funding in a year when there is not enough money for schools, providers, and state salary policy. If not for the unclaimed property growth that we suddenly experienced in November, this could have happened this year.

Pre-funding this year will allow Building South Dakota to operate for several years at the funding level originally planned. It will also give us all time to see how quickly the grant applications are made and how quickly dollars are allocated. Over the next couple of years, additional funds can be allocated to add to the $30 million, so that we can keep pace with the funding level that was planned.

By pre-funding Building South Dakota with $30 million this year, we guarantee that we'll receive more funding than was planned in FY15. In fact, we will appropriate the dollars a year early in FY14, so Building South Dakota will receive, yet this year, nearly as much as it was projected to receive over three years.

Pre-funding means Building South Dakota will not compete with schools and providers for ongoing dollars. Doing this frees enough ongoing dollars to fund schools, providers, and salary policy at a higher level.

The second approach uses one-time dollars to pre-pay outstanding bond liabilities. I propose using $58.1 million to pre-pay four outstanding South Dakota Building Authority bond issues, by either calling them or escrowing funds now to pay them at maturity. This will save $6.3 million of general funds in FY15 and future years.

This slide shows $30 million and $58.1 million – $88.1 million total in one-time uses, but remember the increase in FY14 unclaimed property only totals $68.5 million. Where does the rest of the one-time money come from? Remember at the end of FY13, the state had a nominal surplus of $24.2 million. At the end of June of this year, we reported a nominal surplus of $24.2 million. Under the law, those dollars automatically went into our reserve funds. The Legislature never had the opportunity to appropriate them or to consider how to use those dollars. I propose we use part of it to pre-pay bonds. Last year, state cash flow funds, into which these dollars are now invested, earned only 1.3 percent interest. Currently, this year so far we are earning 1.1 percent interest. It makes sense to one-time dollars to pay off higher interest bonds. This is a prudent use of one-time dollars to remove a liability, just as in your own home you might use an inheritance to pay off your mortgage early. It doesn't affect your net worth. It offsets the asset against the liability. But it does mean you don't have to make those mortgage payments anymore, just as we won't have to make $6.3 million in principal and interest payments out of the general fund anymore.

Let's look at that in detail. These are four bond issues I propose we pre-pay. They are for state facilities, and you can see the principal and interest payments are covered with general funds.

These bonds financed the Mickelson DCI building here in Pierre. The second one is part of the Board of Regents science facilities all over the state in colleges and universities. The Mickelson Human Services Center in Yankton is the third bond issue. Finally, the Mickelson Human Services Center dietary wing is the fourth bond issue.

The second column shows the payoff amount for each bond. At the bottom you can see the $58.1 million that I am proposing to spend in pre-payments. Pre-paying these bonds will save $6.3 million annually, in red there. We'll also save $13.3 million in future interest and fees, primarily from the first two bonds listed. Pre-paying these will result in substantial interest and fee savings over the life of the bonds as their yields are currently over 4.5 percent.

We can't call the last two bonds issued. There are minimal interest and fee savings, but we can pre-fund an escrow account that will pay the bonds at maturity. This gets the annual principal and interest payment off our general fund obligations.

These four bonds, if prepaid, will result in the red number there, $6.3 million in general fund savings for FY15 and future years. As I mentioned, the $13 million I am not even talking about, that's in out years. The $6.3 million we realize right away in FY15 and in other years beyond. Remember the $6.3 million; you'll see it on the next chart.

Pre-paying the bond will reduce FY15 expenses. Remember the cost of funding minimal increases including inflation at 1.6 percent is that $62.9 million figure. In other budget areas, we have expense increases and some expense decreases with a net expense increase of $5.2 million.

Pre-paying the bonds as I just demonstrated in the prior chart decreases expenses by $6.3 million. If we want to fund K-12 providers and salary policy at 3 percent rather than 1.6 percent, it will cost us an extra $16.9 million. By using the one-time dollars as proposed, we increase ongoing revenue to $78.7 million. By pre-paying bonds, we cut expenditures down to $78.7 million. These two moves allow me to propose a budget to you that reaches 3 percent funding increases for schools, providers, and state employees.

That's a broad look at the budget. I'll detail it for you more, but I want to step back now and give you some overview. Things looked pretty bleak in September, but today's outlook is better. Before I detail the proposal any further, I want to take a few minutes to talk about South Dakota's economy.

This chart plots South Dakota and the United States nonfarm employment. Nonfarm employment is closely watched because it provides a timely measure of the health of the labor market and overall economy.

South Dakota nonfarm employment is the blue line, and it's measured on the right scale. The United States is the red line, and it is measured on the left scale. We use a ratio chart so that it is fair to compare those lines one to another if you have the similar ratio on the left and on the right, and we do.

Looking at South Dakota, the blue line. Prior to the recession, you can see we were experiencing strong employment growth. We were adding nonfarm jobs. However, when the recession hit employment levels dropped. In total, 12,300 jobs were lost in South Dakota, or a decline of about 3.0 percent. In 2010, we began regaining jobs. In 2012, you can see we surpassed our previous employment peak. That's the dotted line. We bumped up against the peak and kept on going. As of October of this year, South Dakota total employment was 420,200 people, which is 2.0 percent above our prerecession peak. Only 16 states have surpassed at all their prerecession peak. We're 2.0 percent above our peak. So, South Dakota is fortunate.

Now look at the red line. The United States was adding jobs until the recession when employment dropped. In total, 8.7 million jobs were lost in the United States, a decline of 6.3 percent. Remember, ours dropped only 3.0 percent. As of October 2013, the US employment was 136.6 million, still 1.5 million jobs below the previous peak, or about 1.1 percent below. You can see the bracket on the right that shows the dotted line is still above the solid red line. There is still a gap between current levels and the previous peak.

It took South Dakota 48 months to return to peak employment. For the United States, 69 months and counting, we are still below our prerecession peak. So again, South Dakota has much to be thankful for.

The next four charts display key indicators that the South Dakota is outperforming the US economy.

The first chart, the top left graph looks at some of the same things we just looked at in a different way. It looks at nonfarm job growth of the United States and South Dakota, only the percentage of growth. Since 2007 in South Dakota, our nonfarm growth has averaged 0.8 percent – almost 1.0 percent a year. The United States average during that period is 0.0 percent. They were up. Then they were down. They still haven't regained where they were. So, again a good thing for South Dakota.

The top right chart shows South Dakota's unemployment rate remains significantly lower than the US unemployment rate. Last month, the national unemployment rate was reported at 7.3 percent compared to South Dakota's rate of 3.7 percent. South Dakota's unemployment rate is nearly half of the United States rate. Our rate is 2nd lowest in the nation behind only North Dakota.

The two bottom graphs show South Dakota's income has grown at a faster rate than the United States since 2007. The bottom left shows South Dakota's nonfarm income growth, which has averaged 4.9 percent since 2007, while the United States nonfarm income growth has been 3.1 percent. The bottom right brings in the effect of ag income as well. It shows Per Capita income. In 2007, we were just 93.0 percent of what the US average was. You can see ours grew above the US average. By 2012, we were 103.8 percent of the US average. South Dakota's 2012 per capita personal income was $45,381 per person, compared to the US average of $43,735 per person. We're about $2,000 per person above the US average.

Of course, our strong farm economy has been a significant reason for the growth in per capita income in recent years. Overall, we are fortunate that South Dakota continues to outperform the national economy by most measures.

Let's go back to the budget and we'll take a look at the tax revenues upon which our budget is built.

For the past three years, we have taken a prudent approach to estimating revenues. We use sound, cautious economic assumptions, based on the input of the Council of Economic Advisors from all over South Dakota. We select revenue estimates that have a high probability of attainment, not just a 50 percent probability, but a high probability of attainment. We use long-term baselines to protect ongoing expenses from short-term fluctuations.

I very much appreciate that you as Legislators have taken this approach as well. Over the past few years, the Legislative Research Council's independent revenue projections have been very close to the Bureau of Finance and Management's revenue projections. You have adopted estimates within those projections, and I appreciate that.

We have a lot to be proud of in South Dakota. Our economy has weathered the recession well, and we have continued to outperform most of the rest of the nation. Why is that? I believe partly because we have continued to be good stewards of our state. We brought our budget into structural balance, and we've kept it there.

We have resisted the temptation to over-estimate revenue. Many states do this, very common. We don't adopt overly optimistic revenue estimates. If the revenue does come in better than projected, we spend it after it is in hand. And when in hand, we propose not only to spend the improvement in the revenue as a one-time expenditure mid-year when it is more identifiable, but we also build it into the base for next year's ongoing expenses. When we have the opportunity, we also reduce liabilities.

We are in an enviable position because we made difficult decisions three years ago, and we have adhered to structurally sound management principles. That means, even in a year when revenue growth is a little slow, our budget discussion can be about increases, not about freezes or cuts. Being conservative is very important as we estimate revenues, and I'd like to take a look at that next

You've seen this chart before. It's a history of ongoing revenue estimating. Ongoing revenue estimating compares what the legislature originally adopted when they adopted the budget for the following fiscal year and what actually came in at the end of that year. I show this chart every year because it reminds us all of how important it is to continue to maintain fiscal discipline.

This chart shows the history of the Original Adopted Legislative Estimates and actual receipts. Before FY2009, receipts were close to the estimate, but you can see how the recession reduced our revenue in FY09 and FY10 and our receipts were much lower than the adopted estimates.

We got back on track and have been more conservative as the receipts have exceeded the estimates for the past few years. In FY14, it appears the revised estimate will again be higher than the adopted estimate by about $33.2 million. It's important to remember though the FY14 estimate at this stage would be very close to the adopted estimate if not for that unexpected windfall from unclaimed property.

Let's take a look at detailed revenue revisions for the year we're in right now, FY14.

This chart details the changes from the estimates you adopted last March to what we now believe will be received by the end of this current year. This is again the current year which began last July 1, and will end next June 30th.

Sales and Use Tax collections have improved the past two months and the estimates have increased by $4.7 million. The Property Tax Reduction Fund estimate has been lowered by $2.9 million, primarily due to soft video lottery receipts so far this fiscal year. The Contractor's Excise Tax and Insurance Company tax are both up $1.1 million and $1.8 million, respectively, due to improved collections in these areas.

The ongoing unclaimed property estimate, of course, increased dramatically from $29.1 million to $67.5 million due to the windfall that was recently received. That's an increase of $38.4 million over the adopted estimate.

Licenses, Permits, and Fees are down slightly, Net Transfers down slightly, Trust fund transfers slightly higher.

The Bank Franchise Tax – let's look at that. It's been revised lower. Remember last year in the adopted budget, we included a historical average amount less 1 standard deviation to project what would be our bank franchise tax, especially for bank card tax in ongoing receipts. We projected $16.6 million of ongoing bank card tax receipts and $6.6 million in other bank income, traditional franchise banking income. A total of $23.2 million in the adopted estimate.

The bank card portion of the bank tax has been revised lower, now projected at $9.5 million, or a decrease of $6.1 million compared to the adopted estimate. That accounts for the majority of the reduction in the bank franchise tax estimate. This represents an 18.7 percent loss of the total growth over the adopted estimate.

Other ongoing receipts revised down slightly by $3.1 million, primarily from a decrease in severance tax estimates.

In total, ongoing receipts for FY14 now are revised significantly higher by $33.2 million compared to the adopted estimate. You can see, but for the unclaimed property receipts, it would actually be a revision down. The unclaimed property receipts gave us a positive number which would otherwise have been a lower number.

Let's look at FY15.

This chart compares current revenue estimates, the ones we just revised as of today, to what we think FY15 will bring. FY15, of course, starts next July and ends June 30, 2015.

Sales tax is projected at $835.2 million, up $25.1 million for FY15. There are two limits on growth in the sales and use tax line that have impacted the estimate. First, FY15 represents the first full year of the collection allowance that retailers are starting to take out of this tax. That collection allowance starts next month and reduces sales tax by about $5 million in FY15.

Secondly, under current federal law, South Dakota will lose the ability to assess sales tax on internet access service fees. Don't confuse this with sales tax on internet goods purchased. It is a tax on what one pays to their provider to have internet services. Starting on November 1, 2014, we will no longer be able to asses that tax which is currently in law. The resulting FY15 sales tax loss is about $5.4 million. These two revenue losses, of course as I mentioned, have been incorporated into the $835 million number. That's net of those two losses.

The property tax reduction fund revenue is projected to grow by $2.1 million, reflecting moderate increases in video lottery.

The contractor's excise tax is projected to grow by $5.3 million as we expect continued growth in construction activity in 2015.

The insurance company tax also projected to grow $3.5 million in 2015 as insurance premium increases occur.

Ongoing unclaimed property receipts, I mentioned earlier, are projected at $67.5 million. No increase from the current level that we just collected earlier last month.

The License, Permits, and Fees category and Net Transfers In category are expected to show small increases of $1.2 million and $0.6 million.

Trust fund transfers are projected to increase $2.1 million due to improving returns in the financial markets. Of course, the stock market went up so the value of all our trust funds is up. Multiply that against the average market value over 16 quarters, times 4.0 percent, and that's what you get that's up.

The bank franchise tax is expected to grow by just $0.5 million, with total collections at $17.5 million in FY15. Again, some perspective on that tax. Over that past 8 years, which includes the recession and lower collection amounts, average collections from bank franchise taxes is $30 million, so this revenue source is significantly lower than historical levels.

The other ongoing receipts are slightly lower by $0.4 million in FY15, due to the decrease in the sale-leaseback annuity, and another as I mentioned is a decline in severance taxes.

In total, FY15 receipts ongoing are projected at $1,393.7 million with a growth of $40.0 million over the revised FY14 estimates.

Due to the conservative approach used to project revenue, we are able to fund additional growth in expenses that we would not otherwise be able to fund. The 2013 Legislature adopted a budget which left a structural surplus on the bottom line of FY13 that is the difference between adopted ongoing revenue and adopted ongoing expenses. $5.5 million that is the difference between adopted ongoing revenue and adopted ongoing expenses.

In FY14, the revisions to ongoing revenue growth compared to the actual receipts as compared to the adopted estimates was $33.2 million, as I mentioned a little bit earlier. I just mentioned the growth in FY15 we believe will be about $40.0 million. In total, there is $78.7 million of ongoing revenue available for increased expenses in FY15.

Now that we've talked about revenue, let's look at expenses in detail.

As we look at new spending, our first priority must always to be sure that we do not fall back into structural deficit. How do we do that?

Well, we spend new dollars only when the revenues to support them are highly probable.

We increase ongoing spending cautiously, in areas that we can sustain long-term.

And we use one-time dollars to reduce liabilities or ongoing expenses.

The funding formula for state aid to K-12 education and special education called for a 1.6 percent increase, but by utilizing the one-time funds as shown earlier, I can propose to you a 3.0 percent increase for K-12.

I am also proposing a 3.0 percent increase for the Technical Institutes.

The Board of Regents, of course, does not have a funding formula, but instead makes specific requests for specific increases. This year, I'm recommending funding for specific items which total a 2.6 percent increase. On top of that, on top of that 2.6 percent increase, but not included in that, I am recommending that we use general funds to freeze university tuition for in-state, on-campus students. These dollars will go the Regents but will be passed into the pockets of our university students in the form of lower tuition costs.

The formula we use for Medicaid provider increases would call for a 1.6 percent increase. It is based on prospective inflation, but I am proposing the same 3.0 percent increase that K-12 and others are receiving.

Finally, I would propose a 3.0 percent cost of living adjustment for state employee salaries.

I am not proposing use of one-time funds to augment any of these increases this year. The increases I am proposing are all ongoing increases that will be built into the base.

Now this summarizes my FY15 recommended ongoing expenses.

First, education as a general category - $19.2 million. Medical and Provider Assistance - $39.2 million. State Employee Compensation package - $20.3 million. All the rest - $6.2 million. As I mentioned, the bond pre-payment savings of $6.3 million brings us to a total general fund increase of $78 million in ongoing expenses.

Those are all the major categories. Let's look at the major categories in more detail. We'll start with Education increases of $19 million.

First, State Aid to Education - $8 million. This includes 3.0 percent inflation in general education, special education, and sparsity payments.

As I already mentioned, I am proposing a Regents resident tuition-freeze as a proactive step to keep college affordable. The Board of Regents in-state resident tuition freeze would be $4 million to guarantee there will be no tuition increase for in-state, on-campus students for the 2014-2015 school year.

Similarly, I am recommending a Technical Institute tuition buy-down of $1 million cost. I am proposing that $1 million buy-down tuition at the Technical Institutes up to $5/credit hour. It's similar in application to the way the Board of Regents will help hold down tuition. Similarly this will allow the Technical Institutes to hold down tuition.

Board of Regents M and R - $1.6 million. This is the 2nd year of a 4-year plan to gradually increase our allocation in the budget for maintenance and repair to reach 2 percent of the replacement value of our state buildings. This would get us step two of a 4-year plan.

Board of Regents utilities - $1.2 million to cover increased utilities seen in both the current fiscal year and projected in FY15, primarily in natural gas and propane.

Also to ensure we have an adequate number of physicians to take care of South Dakota patients, we have to expand our medical school class. The Medical School expansion of $1 million would allow the Medical School to add 11 new MD students next year. When fully implemented, they would keep adding 11 to each entering class, so we would eventually have a

Medical School that would have 44 more students when fully implemented than the Medical School currently has in their current 4-year set of classes.

The Technical Institute bonds – this is an $875,000 budget recommendation due to the passage of HB1098 during last session. The state committed to matching the Technical Institutes financial commitment to bond payments on a 1:2 ratio. This fulfills this commitment.

Technical Institute Formula of $800,000. This is a 3.0 percent formula increase. You can see the other Technical Institute payments are on top of that last $778,000 figure. The $778,000 alone is the 3 percent increase.

Let’s move one. The next major category is medical assistance. As you can see, totals $39.2 million.

Medicaid Provider Inflation is $15.7 million. The majority of this is $12.0 million for a 3.0 percent inflationary increase, on average, to Medicaid providers. The remainder is comprised of $1.1 million in Child Care Direct assistance, $1.8 million mandatory inflationary increases required by the federal government, as well as increased inflationary costs related to expanded mental health services and TANF related services. Most of it is a flat 3 percent increase on average to Medicaid providers.

FMAP, the federal medical assistance percentage is shifting. South Dakota’s blended rate will now become 47.88 percent. That means out of every dollar spent in South Dakota on Medicaid, South Dakota pays 47.88 cents and the federal government pays a little over 50 cents. This means as we shoulder more than 2.0 percent more, it means $15.6 million is simply shifted from the federal shoulders to our shoulders. We don’t get any more services for it. We don’t get any more payments to providers for it. They don’t get anything more. It just means that when a dollar is paid to them, more of it is coming out of the state pocket than the federal pocket. That probably is going to happen again next year. This is as I mention a cost shift from the federal government to the state.

$6.7 million is Growth in Eligibles and Utilization. We have about 115,000 to 116,000 people on Medicaid and CHIP today. The rate of enrollment growth has slowed, even flattened, and in some months even gone down recently, but we know that as people start to enroll in the Affordable Care Act exchanges or go to their insurers, they will be steered to Medicaid. Those who are eligible but not enrolled today – what’s called the woodwork effect – they will come out of the woodwork where we don’t see them and don’t know them, and haven’t enrolled them. They will come out and enroll. We do expect there will be growth to some degree. As individuals go to the federal exchange to seek coverage, they will be steered to the state. Right now, we are already getting paper forms – flat files – from the federal government saying check this person, and check that person. They look like they are eligible. We have to reply they are already enrolled, they are already enrolled, and they are already enrolled in almost all of the cases. But some as more and more people go on to the exchange, we will find some and that enrollment will grow from those currently eligible.

In addition, those already enrolled tend to increase utilization over time. Between increased enrollment and increased utilization in Medicaid and our Correctional Healthcare system, we are projecting increased expense of approximately $6.7 million.

There is another miscellaneous group of $1.2 million which includes various increases and decreases such as utilities, internal service rates, food service rates, expanding our workforce initiatives all related to medical and provider assistance.

I am not recommending to expand Medicaid in the FY15 budget. The implementation of the Affordable Care Act continues to be unpredictable and chaotic. From the delay of the employer mandate, to postponing the shop exchange, to the one-year postponement of the cancellation of noncompliant policies, to the initial operating failures of the federal exchange, I continue to have doubts about the federal government's ability to deliver on their promises.

The next slide shows the recommended changes for our workforce. In any organization, the most important resource is the employees. For state employee compensation, my recommendation I am proposing a 3.0 percent cost of living and market adjustment for all permanent state employees.

I am also recommending the continuation of the Performance and Compensation Equity system that Governor Mickelson put in place for FY15, with 3.0 percent adjustments towards job worth for employees paid below the midpoint of their pay range.

I am proposing that we continue the Career Banding and Pay for Performance system that was put into place last year. This allows these employees to receive increases towards market based on their performance evaluated against established accountabilities. This is in lieu of the flat 3.0 percent that others would get. This is performance driven. Some get zero of that money.

Following the completion of a total compensation market analysis, I am also recommending funding for Targeted Compensation Adjustments for a small number of mostly vocational jobs that are below market, experiencing high turnover, a decline in applicants, or are difficult to fill because of the nature of the work. This includes custodians, groundskeepers, and direct-care providers such as nurses' aides. I hope you will support me on that.

Even with aggressive management of our employee health plan we had another year where estimated savings were not realized. For the employer contribution to the state employee health insurance, I am recommending $6.8 million to solve the structural deficit in the base rate.

The total recommended general fund increase for the state government workforce is $20.3 million.

Other recommended ongoing increases include Maintenance Repair - $3.5 million. Again, this is the second year of the 4-year plan to increase the maintenance and repair budget to get our dollars allocated to 2.0 percent of the replacement value annually.

For Agriculture Rural Rehabilitation, I am proposing $460,000. The Rural Rehabilitation Fund works with local lenders to help farmers and ranchers with financing needs. Important agricultural development efforts have slowly depleted this fund, reducing the funding available to assist local farmers and ranchers. In order to prevent further erosion, I am recommending funding to correct a structural shortfall that we have in this program.

For Drug and DUI Courts, I am proposing $396,000. Over the past several years Drug Courts have proven a successful alternative to incarceration and have reduced recidivism. I am recommending funding to establish a Drug Court in Codington County, as well as expanding the DUI Court in both Pennington and Minnehaha Counties.

For Utilities and Internal Service Rates, $351,000. The fourth item includes increases necessary to numerous agencies because utility costs and internal service rates charged to the departments by the bureaus are also expected to increase. In other words, as the bureaus' costs increase because of things like utility costs, or employee compensation, or recommended budget changes, that works into the rates they charge the other agencies in state government.

For Adult Education and Literacy, I am proposing $325,000.   That is an increase as a result of reduced federal funding from the US Department of Education Workforce Investment Act. In order to continue to provide education services at the current level throughout the state, I am recommending to maintain this budget with general funds.

Second to the last, we've got Increase Jail Rate to Counties. Apart from the reform efforts in last year's Public Safety Improvement Act, I am proposing $135,000 to increase the rate paid to help counties keep up with jailing expenses. Counties have done a good job of tracking jail bed days used by the state for parolees, and the data shows that this increase is warranted and fair.

Finally, Miscellaneous Increases and Decreases of $1.1 million.

Now that we've talked about ongoing expenses, I want to talk about how I propose to spend the significant one-time dollars that are available in FY14.

I spoke last year in the Budget Address about "structural soundness." I view one-time dollars as an opportunity to increase our structural soundness. There are different ways you can do that. I see four different ways we can do that.

One, we can eliminate liabilities, as I am proposing this year by pre-paying bonds.

Second, we can build a new asset or improve an existing asset. Last year, I talked about reinforcing the floor in the rotunda as a good use of one-time money to improve or secure an existing asset.

Third, secure an asset. Something you've already got, protect it from deterioration, so you can preserve it.

Fourth, we can endow something, an ongoing program in the future.

My proposals for one-time funding this year fit into these categories. First, though, I want to explain where the one-time money came from because there is a lot of variety of sources where the one-time money came from.

This chart shows the sources where they came from.

First the Legislature, you, left a nominal surplus of $1.7 million in the adopted FY14 budget. If you look at the bottom, I talked about how revenue has fallen, but you also have to include where you left us and against that net the change. The top number there, $1.7 million, and the bottom in red net off against each other if you will.

Second, the increase in unclaimed property one-time receipts. This increase in one-time unclaimed property receipts over the adopted estimate this year totals $30.2 million. In other words, we are getting $30.2 million more in one-time money this year than we thought. It is an additional one-time money available that you have not appropriated yet. Most of this is the 5-year-old and 4-year-old property. Just more than we thought would come in has come in.

Liquidation of 10-45B account - You remember that we had an old large project tax refund program that expired at the end of last year. In that, if you had projects over a certain size you automatically qualified for tax refunds. When the old program was in operation, the Revenue Department would set aside, in advance, the tax revenue eligible for refund on qualified projects. Some projects though never claimed the refunds, and the time for them to do so is now up. We have $19.4 million in un-refunded dollars now available on a one-time basis.

Bank Card Tax Reduction - You remember that, last year, there was great uncertainty about the bank franchise tax. We knew the tax would continue on an ongoing basis, but because of the one year of uncertainty, we included a one-time reduction of $16.6 million in our adopted budget. Some of those issues have been resolved, and we are able to collect these dollars after all. That means this $16.6 million is now available as one-time funds because it wasn't appropriated because of the uncertainty of receipt.

Reversion of Unexpended Carryover - Two years ago, you appropriated $5 million in one-time funds at my request to the New South Dakotans program. That program has worked more slowly than it hoped, so $4 million of the $5 million is reverting. That will be available for re-appropriation.

Increase in Ongoing Unclaimed property - This is the increase in ongoing unclaimed property receipts which we just received. It is available one-time in FY14. Of course, it's in the base of revenue we are projecting to spend in FY15 on an ongoing basis. The fact that it shows up as ongoing this year, unexpectedly, means we can spend that increase once.

Change the rest of Ongoing - This is the net negative number in ongoing revenue which impacts FY14.

Transfer from Property Tax Reduction Fund - This is the transfer from reserves that I already discussed. We will be using a portion of the surplus from the end of last year to pre-pay bonds and free-up ongoing funds.

In total from revenue changes, these are all revenue changes; we will have one-time funds of nearly $125 million in FY14. That's from revenue changes.

In addition to one-time revenues, we also have some one-time money because we know now moving into almost the mid-point of FY14 that some of the expenses you appropriated dollars for we are not going to need all of those dollars. They are available for FY14 now. We have on-time money because our expenses are lower than we projected in a couple of major areas.

First, the Revised Medicaid Eligibles Revision. As I mention, we've seen a flattening out of growth in Medicaid enrollees. During the recession, there were some months where we added a thousand people to the Medicaid rolls. Over the last several years, that increase in the Medicaid rolls month after month has slowed and flattened out. In some months we have actually seen a slight decline. As the federal exchange gets ramped up, we think we think we will see that start to grow again as exchange participants are steered to Medicaid. For FY14, we haven't seen it yet, and we are almost half way through the year. We are reducing our Medicaid eligibles down by a little over $6 million. Again, updated projections still show growth but lower than anticipated.

State Aid to General Ed Revision - Property valuations for taxes payable in 2014 increased more than budgeted for in FY14 leading to increased local effort. This does not mean there is less money for schools. It means there is more property tax revenue available. That gives some relief to state aid. The see-saw effect will cause us to whip saw to the other side, and we will have to pay a little more in a future year. In FY14, there is a little bit less to pay than we had expected.

Finally, we have a modest Continuous Appropriations change related to a Fire Premium Refund allocated to the counties. It's a little bit higher than we expected. That nets against the red numbers and reduces the total decline in adopted expenses to $11.8 million. If you add the savings and expenses to the increases in revenue, you get a total of one-time funds available of $136 million.

Next, I'll take you through my proposals to spend these one-time dollars. The first category is shortfalls in FY14 and a few pretty routine expenditures.

The State Employee Health Insurance shortfall - The FY13 Health Insurance program costs increased significantly more than expected before last year end, and this impacted the base rate that was set for FY14. Even after we revised these estimates during the last session, costs still increased to a far greater degree than the trend line would have indicated they were going to. When coupled with savings estimates over the last two years that were not realized to the extent expected, $8.8M is necessary to fill the existing funding gap.

The second item, as with the employee health plan, Correctional Health has also seen an increase. Already this fiscal year, the costs incurred by high-need and high-cost inmates have surpassed the expenditures paid last year during the same period by 76 percent. This year, I am recommending $2 million to cover the shortfall within the FY14 budget and another $1.5 million to establish a reserve so we have a small cushion when unforeseen inmate healthcare expenditures occur.

After the increases of the past two years, we have replaced our actuary and hired a different actuary that we hope will help us reach better employee health projections. Our new actuary recommended that we create a $6 million reserve to create a cushion for cost overruns in the plan. This $1.1 million one-time expenditure, when matched with federal and other funds, will get us about halfway there toward the $6 million reserve.

DOE Technology upgrades - $600,000 of the $1.1 million is to upgrade servers and other infrastructure at the K-12 data center. $500,000 is for a new E-grant system to replace the outdated system that manages grant reporting.

Revised Utility Projections - The fifth item is an increase of $780,000 for projected in utility cost increases for prisons, college campuses, state mental health and developmental disability facilities, and National Guard armories.

Internal Service Rate changes - I talked about how charges or changes in cost to the bureaus get passed on to the agencies. The rates charged by the bureaus are expected to increase this year more than anticipated because of cost increases in health insurance, utilities, and operations. These funds and the internal service rate changes are needed for agencies to pay these higher rates.

There are some miscellaneous increases and decreases that net to almost $656,000.

Grand total of the general bill amendments for the year we are in right now is $16.7 million.

Here are a few more one-time proposals that are consistent with things you've seen before.

Tax Refunds for Elderly and Disabled - This the annual appropriation that refunds sales and property taxes for elderly and disabled people that meet income guidelines.

Mountain Pine Beetle treatment - As in the past few years, I am proposing to use $350,000 to treat state lands and protect them from Mountain Pine Beetle infestation.

Watertown Armory land acquisition - I am proposing $152,000 to acquire some land adjacent to the Watertown Armory. The land is owned by DOT so we are paying ourselves, if you will. The increased acreage would provide space for unit training and equipment adjacent to the armory.

Rural Healthcare Recruitment Assistance Program - I know many of you will be familiar with this. We talked about it in the workforce initiative a couple of years ago. This would reimburse medical professionals who comply with the requirements of the Rural Healthcare Recruitment Assistance Program. It helps serve the increasing medical needs of rural areas. It is a commitment we make to physicians and other health professionals when they agree to practice in a rural area for a certain period of time.

Our one-time funds, a total of $136 million – I've got a proposed general bill amendment for FY14 for $16.7 million, what I call normal special appropriations bills of $1.0 million. That leaves almost $118 million, almost $119 million, of one-time funds and some of this you will see is what I have already told you about. Here is how I propose to spend that $118 million.

Pre-pay bonds - First, of course, the $58 million is the largest allocation. This is what I propose to use to pre-pay those bonds that I detailed for you earlier. Free up ongoing dollars, as I have already discussed.

Pre-fund Building South Dakota - Secondly, $30 million to Pre-fund Building South Dakota, as I described earlier.

Cash vs. Borrowing for State Vet's Home - Third, we have successfully brought the State Vets Home project back under budget, but I am proposing that, instead of borrowing the $16 million that was planned to fund the state's share after the federal grant, we use cash instead of borrowing. It won't affect FY15, but it will help us in FY16 and future years. It is a good use of that money.

Eliminate Unfunded Actuarial Accrued Liability for Cement Plant Retirement - Another area where I think we can avoid, or in this case reduce a liability, is to Eliminate Unfunded Actuarial Accrued Liability for Cement Plant Retirement fund. Based on current projections, this will eliminate the unfunded liability entirely.

BOR Health Insurance Tuition shortfall - Due to the one-time increase to the state employee health insurance plan which affects Board of Regents' employees, I am proposing to cover a large portion of the Board of Regents' cost with general funds. Last year, this was not in my budget, and you added it. This year, I am including it in my proposal to you.

SDSU Swine Facility construction - Private donors, including three other states' pork producer groups are contributing to a new, regional swine teaching and research facility at SDSU. This would help complete the funding.

Public Safety Building construction - I am proposing also a one-time use of $1.4 million to construct a new Public Safety building located in Rapid City. The new building would be constructed on property owned by the Department of Transportation and adjacent to the current DOT facility.

Missouri River Rail Bridge repair - The next item is $1.2 million to the state railroad trust fund. Those funds would be used to make additional loans and grants to improve our state rail structure. One possible use of those funds would be an upgrade to the Missouri River Bridge crossing at Chamberlain. It would make possible the further upgrade of that line westward from the Missouri River.

Health Care Provider Loan fund - I am also proposing $1 million to create a healthcare provider loan fund to allow healthcare facilities to make investments in infrastructure to serve the medical needs of South Dakota's citizens. Much of this would be used to comply with new federal regulations like sprinklers and other things that some of our nursing homes don't have the capacity to finance right now or cover with their cash.

New South Dakotans/Dakota Roots - I am proposing using $500,000 for our Dakota Roots program to attract out-of-state citizens to move back and work in South Dakota. As I mentioned earlier, we reverted $4 million of the $5 million that had been allocated to the New South Dakotans program, and I'd like to use $500,000 to continue that program for those companies that are participating, and also advance the very successful Dakota Roots recruiting program.

I will describe a couple of these in more detail. We looked already at the bond payment pre-payment proposal. We looked already at the Pre-fund Building South Dakota.

Let's take a look at the State Vets Home proposal. As you remember, the total cost of the new Vet's Home is $41 million. Of course, the bids came in around $51 million. We have the bids back under budget. We were faced with cost overruns but have changed the plans and are now under budget.

After the $23.6 million federal grant and $1.3 million appropriated in 2013, there is $16.4 million that remains. I am proposing a one-time appropriation of the $16.3 million rather than borrowing to cover the state share to construct the State Vet's Home. Although again this won't save expenses in FY15, it will save expenses in FY16 and every year thereafter. Those monies then are available for other things in future years.

Construction of the new Vet's Home will begin in the spring of 2014 and would tentatively be finished November of 2015. The state veterans could move in as early as the spring of 2016. I appreciate the patience of the South Dakota Veterans and all individuals that dedicated their time and energy to the State Vet's home. We owe it to the State Veterans and South Dakota to finish this project, and I think this is a very cost effective way of doing it.

Here is a little more explanation about the State Cement Plant Retirement fund. When the state sold the Dakota Cement plant, we remained responsible for the separate retirement plan of those employees. We talked a lot about the South Dakota Retirement System. This is a separate small frozen plan for which we are responsible to insure the retirees' promises are met. Unfortunately, the funded status of that plan fund as of June 30 was only 87.7 percent of what the actuaries say will be needed to fulfill the promises made to those employees. This amounted to an unfunded actuarial accrued liability of $7.6 million.

Recognizing this liability last session, you contributed $2 million to help improve that in FY14. However, it remains $5.6 million underfunded still. I propose we cover this remaining $5.6 million liability this year in full, so the retirement fund is fully funded based on the plan's assumptions.

Once we make the move, the Cement Plant Fund would compare favorably, even to the South Dakota Retirement System. If the Cement Plant Fund then joined the South Dakota Retirement System, it would be considered to be 107 percent funded, better than the 103 percent funding of our State Retirement System. That would allow us to combine the Cement Plant Retirement Fund and the South Dakota Retirement System into one plan, meaning this problem will be solved for good.

These proposals I have made will go a long way to improving our state's balance sheet. I'm sure we all have very good ideas on how to spend one-time dollars. However, I believe these proposals will also help us create additional ongoing dollars, not just in FY15, but also in FY16, and years out into the future.

So let's look at our new bottom line. The total recommended receipts in FY14 now are revised upward to $1.476 billion and the total recommended expense the same for a bottom number of zero. Because of all the one-time money that will not be repeated in FY15, the revenue numbers are adjusted downward as are the expenses. Never the less, the ongoing expenses in FY15 in m any areas will be 3 percent better than they are in FY14.

Before I close today I'd like to talk a little bit about state's reserve funds.

Here is the history over the past few years of our state reserve funds represented by the blue line. As you can see from this chart, the reserves spiked in FY04. The state used a portion of that to advance the Homestake Lab, and the rest of it was spent over several years to make up structural deficits. In those years you saw in red in that history of ongoing revenue estimation, when we estimated revenue too high and revenue came in lower than that, we spent the reserves to cover the deficit. From FY08 to FY11, no reserves were used because of spending freezes and the use of federal stimulus dollars. In FY12 the first budget I proposed, we originally saw an increase in the reserves, but we used $20.2 million to cover the costs of the 2011 flood, fires, and the Pine Beetle fights. This year after another increase in the top upper most text box where we added $24.2 million, I'm proposing to use $19.6 million in the lower right most text box in FY14 to reduce liabilities as part of that larger one-time funding use.

Given the surpluses we've experienced in the past couple of years, I know many of you have asked, "How much is enough in reserves?" In our rainy day funds between the budget reserve and our property tax reduction fund, those two funds together are rainy day reserves, if you will. "How much is enough?"

I believe of 10 percent of our general fund expenditures is a prudent target for our state reserves. That is within the range recommended by the National Association of State Budget Officers, and it is considerably less than the average reserves held by other local governments in our state, whether they be counties, cities, or schools. They hold in general more than that in their reserves. I am proposing around 10 percent.

Here is where a 10 percent budget reserve would put us.

If you look at the light green line, you can see 10 percent of general fund expenditures in each of those years. You can see from FY03 to FY07, we exceeded this benchmark. The blue line is above the green. Anytime you see the blue line above the green, we have more than 10 percent. You can see that in FY03 to FY07 we were above the green line. Then we dipped below it during the recession. At the end of FY12, general funds remaining at the end of the year not only replenished the reserve, but also increased it to exceed the 10 percent benchmark. Our use of reserves for emergencies brought us nearer the benchmark. After this year's increase, the use of reserves to pay off bonds and free up ongoing money again brings us very close to that 10 percent mark.

This is the approach I would recommend we follow in the future. When the reserves significantly increase 10 percent of general fund expenditures, we consider other ways to use these one-time dollars.

I want to thank you for your attention today. That's the proposal I have for you. I want to thank everyone at the Bureau of Finance and Management for the hard work they did, and the long hours and sometimes week nights and weekends they spent to put this budget together. I know some of the Governor's office staff put in some long hours, unusual hours. I know there were fiscal agents of some of the state agencies who put in extra hours to put this budget together. It is unusual using these one-time monies in this unusual way took a lot of extra work to analyze how it would impact. Some of it impacted revenues, some of it impacted expenses, and some impacts offset other impacts. It took a lot of work to figure out. I appreciate all the people who worked hard to do that. I want to thank you again for your attention.

I had a few goals as I put together this budget proposal.

First, I wanted to maintain structural balance. You probably guessed that – you have probably heard me say that more than once.

I also wanted to use one-time money to improve the structural soundness of our budget, and I think we will do that if you agree with my proposals.

I wanted to fund above 1.6 percent, if possible, and go to 3.0 percent for schools, providers, and salary policy. We found a way to do that, if you agree. I wanted to fund the Regents tuition freeze and do more for the Technical Institutes. I wanted to fund Building South Dakota at the level we had planned.

This budget achieves all those goals, and it does it in a way that maintains our structural soundness. Because you have joined me in managing our budget responsibly in the past, South Dakota is in a strong position today. Here is what we have done together:

As we celebrate 125 years of statehood, we can proudly say that we've balanced our budget every single year, honestly, without gimmicks.

We have prudently set aside rainy day funds that allow us to address emergencies and seize opportunities.

We have not raised taxes.

We have used one-time dollars to improve infrastructure, endow programs, and pay off liabilities.

We have a state pension fund that is over 100 percent funded, and we have a plan to fully fund the cement plant retirement fund as well.

Because of our work, we can all be proud to have been named the Best Run State in America, and we can all be proud to be the #1 state for business in the nation.

I look forward to continuing to work with you this year. Through your efforts, we are building an even stronger South Dakota.

Thank you so much.