BUDGET ADDRESS OF GOVERNOR DENNIS DAUGAARD

THE STATE CAPITOL – PIERRE, SOUTH DAKOTA – DECEMBER 4, 2012

Thank you for being here today. Today is our opportunity to begin the discussion about the state budget as I offer my proposal for FY14. Before I do that, I want to take a moment to recognize some people here. This is the first time that we have been together as a body since the November election and a new legislature will be sworn in next January. Many new legislators are here today, and I welcome you to Pierre. Also with us today and those I really want to recognize, are some who will not be returning next year. They are friends who have served us and our state well, and I would like us to thank them for their service, if you would join me in doing that.

I would also like to say a special thank you to Jason Dilges and everyone with the Bureau of Finance and Management. Putting together this budget is no small task, especially when you consider they need to project revenue and expenses for a period that begins today and ends in June for the FY13 proposed amendments, and then begins in July of next year and ends fully 19 months from now. They are projecting way out in the future, and that takes some talent and some courage, and I would like to thank them. Let's give them a round of applause if you would.

Today I am offering to you my proposal for FY14. I'll begin by talking about where we've been, and then I will share some information about our economic situation, and follow that with a look at our revenues for the current year and then for the follow year, FY14. I will discuss my proposals for ongoing spending in FY14 and ongoing adjustments in the year we are in right now, FY13. I will discuss my proposals for spending one-time dollars – dollars we don't expect to recur. We are fortunate to have one-time dollars to spend this year, and although I will be offering some ideas, you will see I've also left some of that decision-making to you without any suggestions from me.

Let's begin by looking at what we've done together. The budget I am proposing to you today will be a balanced budget, like every budget in the history of our state. Last year, we proposed to the voters a constitutional amendment to add a clear requirement to our state constitution that requires a balanced budget. This principle is the bedrock our state's financial strength, and I am proud that it passed the legislature and was approved by an overwhelming vote by the people. Why did we need to do that? Some ask that question. Virtually all the states have a constitutional or statutory requirement for a balanced budget. Many, however, balance their budgets only nominally. It's balanced, but in a way that really can't be reliably sustained.

Let's look at some of the ways other states balance their budget. Some states balance their budget by accounting methods which push expenses into the next year. Thirty years ago Minnesota did that. They couldn't balance their budget, and even though their fiscal year was ending at the end of June, they could only afford to give their schools about 70 percent of what they owed them under the state formula funding. They gave them that 70 and then the other 30 the next year. They did that 30 years ago, and they haven't been able to undo it. Every year, the schools are getting 30 percent of their funding late with only 70 percent paid on time in any given year.

A lot of states push their expenses into a future year. Another common trick is to push the last payroll of the year into the next year. If you have two payrolls a month, instead of having 24 payrolls in a year, you push that last payroll into the next year and you have 23, and "Oh surprise, now we're balanced." The flip side of delaying a payment is booking future revenue ahead of schedule. That's what Texas came up with just this budget year that they are in right now. They are in a biennial year. To close a mammoth budget gap over the next two years, Texas devised a plan to collect some taxes sooner. Under that deal, Texas large retailers pay some of their sales tax collections early. That added $231 million to this budget, but it also robbed the next biennial budget of that same amount.

Some states use an asset sale against their ongoing expenses. It's like selling your car to pay your utility bill. It works once, but then what do you do? You don't have that asset anymore. I know many of you are going to remember that just over 10 years ago South Dakota settled a lawsuit against tobacco companies, and we sold to bondholders the right of the revenue stream that tobacco companies promised us. That gave us a lump sum of money, and what did South Dakota do with it? We proposed and voters agreed to put those dollars into the Educational Enhancement Trust Fund. Those dollars have grown from over $300 million to closer to $400 million today. That trust fund throws off distributions virtually every year into perpetuity to support education.

Minnesota did the same thing. Maybe you were aware of that. They sold their tobacco settlement proceeds. What did they do with their lump sum? They used it to balance the budget that year. That money is gone. Many, many states have balanced their budgets over the past decade by making inadequate contributions to their public pension plans.

Virtually every public employee in South Dakota is under the state retirement plan. Policeman, teachers, university professors, DOT truck drivers, every public employee that has a pension plan with the exception of Sioux Falls, whose employees going forward will be on this plan – they're on the South Dakota Retirement System. Many states have balanced their budgets by failing to make adequate contributions to those pension plans to meet the promises they have made to those employees, that when they retire there will be an annuity payment in their retirement years. In other words, the amount contributed to the pension plan was less than the amount actuaries say should be contributed.

Illinois hasn't contributed the appropriate amount in 30 years. The Morningstar Investment Research firm, just last week, published a report that judged 21 state's public pension plans are not fiscally sound. Remember Illinois. They were at the bottom of the list - 43 percent funded. The best was Wisconsin - 99.8 percent funded, South Dakota number 3 at 96.3 percent funded. We're not perfect, but every year we make the contribution actuaries suggest, and we are always adapting to the changing interest rate environment and keeping our plan fiscally sound. We aren't one of those 21 states that are out of whack.

The point I'm making with all these examples is that a state budget can be balanced nominally in name alone, or it can be truly balanced structurally, correctly, and in spirit balanced – in a way that covers ongoing expenses with conservative estimates that we can rely on of ongoing revenues.

Maintaining that kind of balanced budget hasn't always been easy. When I came into office two years ago, many of you here with me made courageous decisions to bring our expenses into line with ongoing revenues, and our budget is structurally balanced. Ongoing expenses are covered fully by ongoing revenues, and that is something we can be proud of.

By acting responsibly, we are building a South Dakota that is structurally sound. A balanced budget is part of that, but it is not the only part. Building a stronger South Dakota – we're structurally sound because we restored structural balance, we don't defer expenses or accelerate income, we use conservative revenue and expense projections, we don't always appropriate every dollar that's available, and the state agencies under my direction haven't spent every dollar that's appropriated either. We save our reserves for emergencies, and we replenish them when we are able. In short, by making cautious decisions and applying South Dakota common sense, we are building our state for the long term.

My focus today is on this theme, "the structural soundness of our state." As I prepared this budget proposal, I saw that we're going to have some revenues that are not expected to recur in the future. They are one-time revenues. I believe we should expend these one-time funds for things that strengthen our state in one of four ways. We should eliminate a liability, build or improve an asset, secure an asset, or endow a program for the future. You will see some of these uses of one-time monies that I propose in the budget offering I display today. I will return to these points later in the proposal, and I hope you will consider them during the coming session as well. We owe it to South Dakota to use the revenues we have available to improve the structural soundness of our state for future generations.

With these thoughts in mind now, let's look at some economics. The United States economy is recovering, but is not yet recovered. These four charts show how the recession has impacted four key indicators and how they have performed since 2007. Look at the upper left hand graph. The US real gross domestic product is the only indicator shown here that surpassed the pre-recession level. Real GDP peaked at $13.3 trillion in 2007. In late 2012, almost five years later, real GDP is at $13.6 trillion, which is a growth of total 2.3 percent since that pre-recession peak five years ago.

In the other chart on the right, US jobs declined by 8.8 million jobs during the recession, and only 4.5 million have been added back. We have only recovered about half of the jobs lost nation-wide.

In the lower left hand, US housing starts declined from nearly 1.5 million starts on an annual basis in early 2007, and in the third quarter of 2012, housing starts were just 786,000 units on an annual basis – a little over half of where they were in early 2007.

The US unemployment rate, in the bottom right hand, remains high. It jumped up to 7.9 percent now, compared to 4.5 percent in early 2007 before the recession. The bottom line is the national economy isn't healed yet, so we need to be cautious going forward.

These charts show by four indicators that South Dakota's economy has out-performed the United States economy over the past several years. The top left graph shows non-farm employment levels of the US economy on the left axis and South Dakota numbers are on the right axis on a ratio scale. US employment declined much more sharply during the recession as compared to South Dakota's decline. US employment declined 6.8 percent from the peak in 2007 to the trough at the bottom of the recession - 6.8 percent drop. In South Dakota, we declined less than half as much at 3.1 percent peak to trough.

The next chart top right, you can see South Dakota's unemployment rate remains significantly less than the US unemployment rate. In October 2012, the most recent figure available, the national unemployment rate was 7.9 percent compared to South Dakota's rate of 4.5 percent.

The two graphs on the bottom show South Dakota's income has grown at a faster rate than the United States over the past four to five years. I am going to refer back to this point, so fix it in your mind. Our income has grown at a faster rate than the United States over the past four to five years. In 2011, our non-farm income grew 5.7 percent compared to the United States growth of 5 percent. Our per-capita personal income growth, which includes farm income along with non-farm income, made us number 1 in the United States from 2010 to 2011 in terms of our growth, which was 11.8 percent. Our strong farm economy was a significant reason. That point again is something I am going to return to later.

South Dakota's 2011 per capita personal income was $44,217 per person, which is 106 percent of the national figure of $41,560 per person. Let me say that again, the average income earned, if you divide the total income by the over 800,000 South Dakotans, is $44,000. In the United States, that average is $41,000. We're fortunate that South Dakota's economy continues to out-perform the national economy by many measures.

Let's take a look at the tax revenues upon which our budget is built. This chart shows projected receipts for FY13. That left column is the numbers you adopted when you adopted the budget. That's in law. The middle column shows what we think revenue will be. It's better in most cases than what you adopted. The right column, of course, is the difference between the two.

Several sources have been revised higher. Sales tax is up $6.4 million, mostly because of a strong July number. They haven't been as strong since July, but they are up in general.

Property tax reduction funds shows video lottery revenue is up $5.7 million as we're beginning to see some return on investment in new line games that video lottery operators are using. This will be the first year since the smoking ban that we've seen an increase rather than a decrease in video lottery receipts.

The third line contractor's excise tax is up $10.6 million. Last March, you adopted a budget which assumed the passage of Referred Law 14, the large project fund. Under that assumption, $7.3 million was allocated for the last half of this fiscal year away from this tax. Because it did not pass at the ballot box, the estimate for contractors excise tax is now higher by $7.3 million. The remaining increase of $3.3 million is due to growth in construction activity.

The ongoing bank franchise tax is down $3.3 million. Our bank franchise tax has been very volatile lately, due to some of the changes in federal banking law and FDIC requirements. That number, the $22.9 million number, is offset below by a negative $16.6 million, as a negative one-time receipt, as we are uncertain when this revenue source will get back to normal. We are going to discuss this in more detail later.

Charges for goods and services is up $2.6 million on an ongoing basis, mainly due to higher unclaimed property receipts. There is also one-time unclaimed property revenue that is shown below the line in one-time receipts. I will discuss that in more detail later also.

Total ongoing receipts – total ongoing receipts – up $24 million compared to the adopted estimate.

One-time receipts are up a net – a net – of $5 million. This is a combination of a positive one-time receipt of $12.6 million in unclaimed property, one-time receipts of $1.7 million from refinancing bond gains, $2.4 million from miscellaneous national court case settlements, $4.1 million transferred from the tax relief fund, and a $1.8 million transfer from the budgetary accounting fund. All those increases are off-set by the one-time reduction I mentioned earlier, $16.6 million one-time reduction of bank franchise tax. Again, more about that later.

In total, the revised one-time collections total to $6 million – $5 million up above where it was when the budget was adopted. Total changes $29 million higher than the adopted estimate in total receipts for the current year – the year we are in right now – FY13.

Now, let's look at FY14 beginning next July. On this chart, the left hand column was carried over from the prior chart. It is the revised numbers. The middle column, of course, is what we are predicting revenue will be from the period July 1 of next year through June 30 of FY14. Fiscal year, again, runs July 1 to June 30 of the following year.

Growth is expected in all categories, sales tax, property tax reduction fund, which you know is video lottery money, contractors excise tax, and insurance company tax are the big four.

The ongoing bank franchise tax we are showing, again ongoing, we're showing estimated at $23.2 million with little growth for FY14. And again, I am off-setting that with another negative $16.6 million of the revenue as a one-time negative down below. Again, I am going to explain why that was done a little bit later. Charges for goods and services are up $15 million on ongoing basis in FY14 due to some bank reorganizations.

We expect we will begin receiving new ongoing unclaimed property revenue of approximately $15 million more every year. I am going to talk more about unclaimed property in another chart later.

Other ongoing receipts include alcohol taxes, cigarette taxes, severance taxes, licenses, permits and fees, among others.

Total ongoing receipts are up $63 million compared to the revised FY13 numbers.

One-time receipts for FY14 are a net increase of $12.6 million. This net includes the one-time receipt of unclaimed property, which I mentioned a bit ago, estimated at $29 million and off-set by a one-time negative the $16.6 million bank franchise number I talked about earlier. In total, we expect a net of $12.6 million one-time receipts. That's $6.6 million higher than the revised FY13 number. We are not going to use cash carry forward for FY14 as we did last year, leaving total receipts of $1,333.1 million in revenue for next year's budget year. That's $41 million higher than FY13, including both ongoing and one-time receipts.

Let's recap now because it is important to understand ongoing revenue if you want to be attentive to the structural deficit. When you left after adjourning last year, you left $16 million on the bottom line, if you recall. Of that, $9 million was ongoing. Now, I have just told you that we believe revenue in ongoing categories is going to be up $24 million for the year we are in right now – five months into FY13. Next year, we believe ongoing revenue will be up still $63 million more for a grand total of $96 million in ongoing revenue that is available to expend in ongoing expenditures in FY14.

By ensuring our revenue growth is probable rather than hopeful, we have been able to use FY13 ongoing revenue growth to off-set ongoing spending in FY14. Without this, we would only be able to propose $63 million in ongoing spending.

I need to talk to you more in depth about the revenue the state derives from our banking sector. The past few years have been a time of instability in the banking industry in South Dakota and around the world. The economic collapse of 2008 saw the failure of several prominent banks and in response, Congress passed the Dodd-Frank Act. That law has prompted a wave of bank restructurings across the nation. In South Dakota, two of our larger multi-state banks have undergone mergers or changes in their charters. Other multi-state

banks have moved operations to South Dakota. Overall I believe these changes have been good to South Dakota. Our business climate is attracting banks to our state, but one consequence of this change is that South Dakota and the banks are grappling with how to calculate taxes on their bank income - a very changed structure. These banks are national organizations and they need to apportion their nation-wide income among all the states in which they do business. This discussion is ongoing, and I am confident that we'll ultimately see this revenue stream stabilize. I'm hopeful that will be clarified before the end of the legislative session, but I do not know yet today.

Let's take a look at some history of the bank franchise tax. This chart shows ten years of our bank franchise tax and as you can see in the last ten years our best year for this tax was $42 million. A worst case would be nearly zero. I think neither is likely to occur this year.

The next chart shows how we calculated an estimate based on history and statistical analysis. What we are after is how are we going to figure out what is our ongoing revenue from franchise tax that we should use to guide us as we consider ongoing expenditures. This chart attempts to show how we computed an amount to assume for bank franchise tax. Again, I want to stress that while we are counting on this revenue source to return to an ongoing revenue source, we are subtracting any ongoing numbers down below until we can determine the future state of our bank franchise receipts. So, we are showing them up in ongoing and we are taking them away below.

In the box shown in the upper left, you can see again the ten-year history of the tax. The same information you saw in the bar chart in the last chart. In the last ten years, our best year, again, was $42 million. Our worst year was nearly zero.

For today, I asked the folks at the Bureau of Finance and Management to calculate an estimate that looks at our historical averages collected and then makes some conservative assumptions going forward. We took the average of the ten years, which is $27.7 million, and then we looked at the variances and computed the standard deviation. That is of all the collections, 68 percent fall within a fixed range. That range is plus or minus $11.1 million. If you assume a standard bell curve as our distribution of future collections, we can subtract one standard deviation from the mean and be 84 percent confident that future ongoing collections will be at least that high. The number you come up with doing that calculation is $16.6 million. That is the number that is in the ongoing, and that is also the number that I also subtract below because we are uncertain about what it will be near term. The longer term, the $16.6 million, I believe is a very reliable figure upon which we can be relying.

We are being conservative counting on zero from this tax net for FY13 and FY14, but we are projecting that it will be restored to at least $16.6 million in future year's budget. If for some reason, the changes in national law and bank restructuring result in a condition that appears otherwise, I will come to you and ask you to amend our bank franchise tax laws so that we get where we need to be.

Now, the state also derives revenue from banking operations through unclaimed property. The news here is better.

In all states, banks sometimes lose contact with their customers. You might establish a bank account and then leave town and forget that you left $5, $10, or $100 in the account, or you might have a credit card, and you overpay your credit card. You forget that there is that credit balance, and you decide to abandon that card and you use a different card. For whatever reason, banks end up with some accounts where they have a modest amount of money and they can't find the customer. Those banks hold these unclaimed bank accounts for a period of years fixed by law while they try to find their customers. They can't spend that money. They can't use the interest on that money. They just have to hold it for their customer and look for their customer. If the owner cannot be found after the fixed period of years in law, these unclaimed property assets are turned over to the state. That's why the Treasurer puts in the paper, goes to the state fair looking for people – "Hey, Joe Smith of South Dakota, we think we've got property that is owed you." That is where that's from.

Traditionally unclaimed property deposits into South Dakota's general fund were a few million. However, in recent years as banks have merged, or moved their headquarters to South Dakota, or their charter to South Dakota, we have been the beneficiary of more and more national unclaimed property that cannot be attributable to any one person or state. Therefore, because we are the headquarters, the unclaimed property is turned over to the state of South Dakota.

This chart shows the history of unclaimed property receipts coming to South Dakota since 2003. The ongoing revenue is represented by the blue bars at the bottom that look almost purple in this projection. One of the bank restructurings that I mentioned resulted in a one-time payment of unclaimed property in the current FY13 year, the year we are in right now, and that is represented by the green bar in FY13. We did anticipate that payment, but it ended up being a lot larger than we thought it would be. So, there is some one-time money that popped up in the current year.

Another bank restructuring undertaking recently will cause still additional unclaimed property to accrue to South Dakota in FY14. That is represented by the light blue bar, the checkered bar, and that will be ongoing starting next year. We will also be receiving a one-time increase in unclaimed property in FY14 represented by the longer green bar on the right.

In the past, you might remember South Dakota banks were told to hold unclaimed property for five years while they look for their customer. If they couldn't find their customer after five years, it turned it over to South Dakota. This five-year period was set in South Dakota law and then I learned that neighboring states, most of our neighboring states, had a three-year law. Last year I proposed, and you agreed, to change our law to a three-year statute. Next year we will get five-year-old property, four-year-old property, and three-year-old property. The five and the four-year-old property, the one-time bump, is represented by that green bar. In years after that, we will just revert to a three-year-old property, and it will drop down again. The one-time amount by that upper right hand green bar is $29.2 million.

In summary, although the changes in banking have created uncertainty in the bank franchise tax which I think we can correct, they have increased our revenue stream on both a one-time and an ongoing basis for unclaimed property.

Now that we have talked about revenue let's look at the other side. Let's look at expenses.

As we approach new spending, again we need to invest our revenues cautiously and in targeted areas that have long-term sustainability. One-time dollars should be spent in accordance with those principles that I outlined earlier - eliminate a liability, build or improve an asset, secure a current asset, or endow a program for the future. We need to continue to be conservative in estimating revenue in order to maintain our structural balance over the long-term. Remember when I first came into office, in the prior four years, we had every year over-estimated our revenue, and actual revenue came in below projections. Our worst over-estimation was when we over-estimated revenue by more than $50 million. We've got to be careful going forward, and we have been careful in the last two years. Let's continue with that.

Once again, I am proposing a budget that is structurally balanced.

Here is a summary of the ongoing increases that I am proposing, which if you agree, will become part of the base budget. I am proposing 3 percent for state aid to K-12 Education and Special Ed, and this follows the formula funding for the K-12 per student allocation.

I am also proposing 3 percent for the Technical Institutes following their formula.

The Board of Regents does not have a formula funding policy, but instead they make specific requests for specific things. Last year they received a 1.4 percent increase. This year, I am recommending funding for specific items which total a 3.2 percent increase, and I will talk more about those items later.

The formula we use for Medicaid would require a 1.8 percent increase for inflation. In the K-12 funding formula, we look back at historical inflation. Inflation went up for a while, and now it has come back. You may have seen that in the chart earlier. It went up for a while and came back down. It's around 2 percent now. Since you are looking historically at K-12, historically, inflation over the past several years has been 3 percent. Prospectively it's judged to be around 1.8 percent. Notwithstanding that, I am recommending the same 3 percent increase as K-12 and others.

Finally, I propose a 3 percent cost of living adjustment for state employee salaries. I am going to go into some of these things in more detail.

Many of you are going to recall – as an aside – I want to mention that in the last two budgets, we used one-time funds to soften the effects of the budget cuts. Remember, most places were cut 10 percent, schools were cut I think 8.6 percent. One-time funding prevented any of those

recipients from falling to that level. Medicaid providers did not fall to a 10 percent cut, because one-time funds helped avoid that. K-12 did not fall to the 8.6 percent cut, because one-time funds in the last two years prevented that from happening. This year we are returning to formula increases and have funded increases of 3 percent for each of these categories, but I am not proposing the use of one-time funds to augment any of these increases for this year.

Let's talk about the education increases. This breaks down the funding for education. State aid to education is $15.9 million to general education funding on the funding formula, an increase of 3 percent, and also recognizing some enrollment increase projection.

Special Education would increase $6.3 million based on a 3 percent increase, and also aligning the base with increased need. So part of it is inflation – part of it is realignment of increased need.

The Board of Regents proposal of 3.2 percent is $5.3 million. That's on top of the proposed salary increases I will talk about in a moment. The $5.3 million figure includes $1.9 million to establish a physics program, and a doctoral Ph.D. program in physics at USD and School of Mines in support of the Sanford Underground Lab. It also includes $1.7 million for maintenance and repair funding, $1 million for research at the Ag experiment station, and $0.5 million to pay physician assistant preceptors.

Tech Institutes, I propose $650,000 in increased funding for 3 percent and also for enrollment increases.

Again, this is on top of proposed salary increases that I will talk about in a minute.

The other education is technology, sparsity, and consolidation incentives. Education is this first big category of spending - a total of $28.6 million.

A second large spending category is medical assistance, including Medicaid. If a frail elderly person enters the nursing home and can't pay, they are placed on Medicaid. You know the nursing home sends that bill to Pierre. We pay that bill partly with federal money and partly with state money. The next graph I am going to display will show the average percent the federal and state governments each pay for Medicaid, the Children's Health Insurance Program, and others. It is a blended FMAP. Mostly it's Medicaid. I am just going to call it Medicaid for simplicity. Let's take a look.

On this graph, the red line shows the percentage of each Medicaid dollar paid with federal money. If the nursing home bill was $10,000, 60 percent of it in 2008 was paid by the federal government, and about 40 percent of it, or a little less, was paid by the state government. The blue line, of course, shows the state paid percentage. As you can see, as I mentioned in 2008, South Dakota was shouldering a little less than 40 percent of each payment. The federal government was paying the rest. The recession hit and stimulus funding passed by Congress relieved the burden on all states. The federal government said, "We are going to shoulder

more of the burden during this recession. The states are having a tough go." You can see the stimulus money shifted the burden to the federal government away from the state, so our share dropped in 2009, and again in 2010. It was still low in 2011, and then when the stimulus money ran out and we went back to normalized, we jumped back up again and little bit higher than we had been in 2008.

Again, remember that per capita income growth. How is Medicaid apportioned between the federal government and the states? Not everybody is this breakdown that I am showing here. Every state is different. Some states are 50 percent – 50-50 – North Dakota is 50-50. Some states are different. How do they decide who pays what? The federal government uses a three-year average of state per capita personal income to calculate each state's reimbursement rate change. If a state average is growing faster than the national average, the federal government pays less of each Medicaid payment. If the state average is going slower than the national economy, the federal government pays more. What has been happening to our personal income? It's been growing faster than the federal per capita income, and as I mentioned in 2011, it rose by 11.8 percent, the highest rate of growth in the nation. Because our three-year average of per capita personal income is growing faster than the US average, the federal FMAP rate, their share of Medicaid expenses, is going down by 2.73 percent and our share is going up by 2.73 percent. You can see we are getting closer and closer to that 50 percent mark and at the rate we are going. Because 2011 numbers are going to be included not just in this year's three year calculation, but in next year's three year calculation, and the following year's three year calculation, unless we really go upside down in South Dakota. Odds are very high that we will be at a 50-50 share by 2016.

Every percentage point of match costs the state over $7 million in general funds. Let's see how that FMAP change impacts the budget this year. This breaks down the funding for medical assistance, mostly Medicaid. The top line, that $20 million expense, our new FMAP raises our blended rate to 45.8 percent. That means $20 million in lost federal funding that is replaced with $20 million of state. We're not serving any more people. We're not paying our providers any more money. We're just using more state dollars and fewer federal dollars to pay the same bills. That is just a shift in burden from the federal government to us this next year.

The second line, as I mentioned earlier, I am proposing a 3 percent inflationary increase, on average, to medical providers. This costs $13.2 million. If you paid X dollars to set a broken arm of a Medicaid eligible patient, next year you will get paid X dollars plus 3 percent. It would be one way to look at it.

Look at the third line. South Dakota has 116,000 South Dakotans on Medicaid or the Children's Health Insurance Program. More enroll every month. The rate of enrollment has slowed, as the recession recedes, but we still see some enrollment growth. In addition to more people coming onto the rolls, those who are on the rolls tend over time to use services more and more. The Medicaid enrollees who went to the doctor ten years ago tend to go to the doctor more today than they did ten years ago. That is utilization growth. Between enrollment growth and utilization growth, we are predicting we need another $4.4 million.

Add Other Medical Assistance like food services, utilities, bond payments, and we have a total increase of over $39 million to support only the current program. I know some of you expressed support for expanding our Medicaid program, and I'll talk about that in a minute, but I want to emphasize this dollar increase just supports our current program and adds 3 percent inflation.

As part of the state employee compensation recommendation, I am proposing a 3 percent across the board increase, including market adjustments for career band families, where our compensation is significantly below the market. This is something you supported last year, and I am asking you to continue your support. I am also proposing a 3.5 percent movement toward job worth for employees covered under the Performance and Compensation Equity program, and 0 to 4.5 percent performance-based increases for career band employees. Again, this is something you supported last year. Some of those career band salary levels were way out of the market. In IT, and some of our engineers were just way out of the market, and we need to do some things to start moving back closer to the market.

For the employer contribution to employee health insurance, I am recommending $7.5 million. That's an increase of 14.7 percent in health insurance costs to keep the program from incurring an under-recovery. Nationally, since 2008, employer contributions to health plans have grown 40 percent. Our state contributions have grown 14 percent. We had a pretty optimistic belief about how we would be able to control costs. We had some programs in last year's health management effort that we believed would result in some costs, and they are starting to show some cost savings as a result. But they are not occurring at the rate and at the level that we expected, and so we are not putting enough money into the plan and we are going backwards.

Also, we shifted about $12 million in costs to the employee. One way of addressing increased claims is to put more money into the plan. Another way to address it is force the insured to pay more in the way of deductibles or co-pays, and we have done that to the tune of $12 million. Ours is a self-insured program. We don't buy it from the insurance company. We insure ourselves. We set aside a certain amount of money every year, which we believe will cover the claims. That's not happened. In our FY13 budget, we underestimated our health care costs, and this increase will address it from FY14 going forward. I have a one-time request to fill the hole for the current year that you will see in a minute.

Let's look at the next chart. Those three categories make up the vast majority of proposed FY14 increased ongoing spending. We have a little room for new ongoing spending, but not much. As we consider new ongoing spending, again, I want to encourage us to follow responsible principles. We also have opportunities for one-time spending. Again, we want to promote structural soundness with those one-time expenditures too.

Let's look at the bigger picture now. I already talked about the first three. Education is $28.6 million, medical assistance $39 million, state employees $20 million, and what is left in ongoing spending.

Criminal Justice Initiative: We propose to spend $3.4 million of new ongoing money. Earlier this year, I joined with Chief Justice Gilbertson, Senate Majority Leader Olson, and House Majority Leader Lust to convene a workgroup. Speaker-presumptive Brian Gosch was at the initial gatherings to work on our criminal justice system. The goals of this workgroup were to increase public safety, hold offenders more accountable through community supervision, and reduce corrections spending. Last week, the workgroup issued its final report. I hope some of you have seen that. I appreciate the careful thought and study they put into the process. Many of their proposals are policies we should consider, and I will discuss them in the State of the State Address next month.

The recommended FY14 budget includes funds to expand drug courts, strengthen probation and parole, and build our capacity to deal with behavioral health and addiction issues. I believe spending these dollars now may, along with implementing statutory and procedural and policy reforms, I believe it should significantly save more dollars in the years ahead. Again, I will discuss more of this in the State of the State, but I ask your involvement in studying these things, evaluating the facts and the proven evidence based practices upon which they are founded, and judging with me whether they are worthy of support. I believe they are.

The fifth line item proposes to spend nearly $2.8 million for maintenance and repair. Going back in history a little bit, in earlier years to balance our state budget before I became Governor, we departed from a policy that used to set aside 2 percent of our total building values to use for maintenance repair. If we had a building worth $100,000, we would set aside $2,000, and then that would be available for maintenance and repair. In an effort to cut our budget, we reduced that to 1 percent. I would like to return to that policy. I am proposing gradually returning to this approach over four years. FY14 we would budget ¼ of 1 percent as an ongoing number planning to add another ¼ of 1 percent the year following, another ¼ after that, and another ¼ after that to get us up to, not just 1 percent, but 2 percent.

The sixth line items proposes new ongoing spending of $600,000 – an increase for food services based on our service plans, increase for utilities based on our energy manager's projections.

The last line before the total combines a number of miscellaneous items, including additional support to Legislative Audit, support to Weights and Measures, and other items. You can see that is about $0.5 million. These are all proposed FY14 ongoing expenditures.

The following three slides are going to discuss amendments to the FY13 budget. This is FY14 we just talked about. We are going to go back now and look at the year we are in right now, FY13. We are five months into it. Let's look at where we are. A few of the adjustments we are going to talk about are mid-year adjustments where revenue or expenses have differed in our five months of experience from what we projected last March. Others you will see are proposals that I offer to spend one-time money, and I have additional proposals to spend one-time money in FY14 that you will see also in a minute.

Again, I believe that one-time money is an opportunity to strengthen our state's structural soundness. I will repeat it – how should we spend one-time money? This is my philosophy: We should defray a liability. We should build something. We should improve the stability or secure something that we have already built, or we should endow something that will be perpetually available and throw off earnings for some program for perpetuity. Those are my philosophies about one-time money and they will keep out of a structural deficit.

These are the changes I am recommending mid-year for the current year budget – FY13 budget.

Health Insurance: I mentioned that we are upside down. We are not setting aside enough money to cover our claims. There are one-time cash sources and the revenues which offset most of this one-time cost. You can see it is a little shy of $8 million to get us back to where we need to be, and we are covering the ongoing part in our ongoing expenses that you just saw.

The second item: GOED Economic Development. I am asking for $5 million in one-time money to go into the Future Fund for economic development projects. As you know, the voters rejected the large projects refund program, and I respect that decision. Two projects made the decision to invest in South Dakota, relying in part on the availability of that program. They made their decisions after the law was passed, but before it was referred. Once the law was referred, I pledged Future Funds as backup, so these programs could move forward. Bel Brands in Brookings and Baldwin Filters in Yankton were companies that I pledged Future Funds so they would make their decision to be in South Dakota, and both companies made that decision to be in South Dakota. I am asking the legislature to put one-time dollars into the Future Fund to help meet these obligations. There are two lines there: $5 million in general, $5 million in other. It is the same $5 million. It would be spent by placing it in the Future Fund and then the Future Fund would have other fund authority to spend it in distributions to those companies.

Criminal Justice Initiative: I talked earlier about ongoing, one-time startup costs of $2.6 million for this initiative. Again, I am hopeful this one-time investment and the ongoing dollars will offset and reduce a future greater liability and avoid construction costs of new prison facilities.

State Aid to Special Ed: This covers a shortfall in the state aid to special ed formula this year. The shortfall is primarily due to lower property valuation than projected. This will eliminate a current liability.

Cement Plant Retirement Fund: You know over 10 years ago we sold the cement plant, and we froze the retirement plan and closed it. But the amount of money that was in that plan has suffered as a consequence of the poor economy, and there is not enough money to make the projected retirement payments. You might remember those of you who were here last year, we put an extra million dollars into this fund as a start. I am proposing another couple million. The shortfall is in total between $12 million and $15 million according to the actuary.

Internal Service Rates: These are rate increases occurring in the Bureaus due to cost increases for operations and a major software upgrade to several departments. Funds are for agencies to

cover these rate increases. This will again reduce a current liability and leverage federal funds as well.

State Aid to General Education: This covers the shortfall in the state aid to general education appropriation. It's short because of a lower property valuation than was budgeted, and thus state general funds have to make up the difference.

Veterans Services for Higher Education: These are funds that will be available to the higher education institutes, both the Board of Regents and the technical institutes to provide veterans services on those campuses.

Finally, the GOED Research Commerce Grants: This is to start a proof-of-concept grant program. The Board of Regents and the Governor's Office of Economic Development would work together on this. It would support a program to provide small, less than $50,000 proof of concept investments in research that is believed to be commercially viable. They are trying to turn research into a business. If commercially successful, the investment would be repaid. If not, then it would be lost. So, there is a little bit of risk, but the idea is to encourage commercialization of research and support entrepreneurs right here in South Dakota.

Additional proposed amendments: DOE Jobs for America's Graduates Program: The Department of Education would provide mini-grants to school districts to help implement the Jobs for America's Graduates program at school districts that are in need. The JAG program is primarily a dropout prevention program. It's been highly successful across the nation to help keep our students in school and on a path to success.

DOE Teacher Evaluation Software: This would pay for the one-time costs of the teacher evaluation software, which will provide a consistent teacher evaluation tool that can be used at all public school districts across South Dakota. Uniform and consistent evaluation of our teachers is a key component of our education system's new accountability model, and this will provide a tool that school districts can use – they can choose to use – which will meet accountability standards. School districts will be free to create or use alternative credible tools of their own, if they wish, but many districts have requested assistance in this area.

DOE Sparsity Money: This covers a small shortfall in sparsity funding due to more students than budgeted.

Technical Institutes M&R: This increase in other funds authority is needed to appropriate maintenance and repair fess to the Technical Institutes.

BOR Budget Authority: Due to an increase in the Higher Ed Facilities Fund for M&R and enrollment growth.

Technical Institutes Funding Reduction: This is due to actual student numbers being 179 fewer than budgeted for FY13. Therefore, these funds are no longer needed and can be eliminated from the FY13 budget.

Medicaid Enrollment Revision: We are seeing Medicaid and Children's Health Insurance Program enrollment growth flattening out. We still see growth, but the growth is much more moderate than it was a year ago. Even when we adjourned, we weren't confident that enrollment would be as slow as it has turned out to be. A lower growth than previously anticipated is allowing us to unappropriate those dollars, if I can call it that.

Let's talk about some emergency specials. I don't know that these would be really emergencies in the sense that the fire bell is ringing, but they are two-thirds votes in any case, and by including an emergency clause, they can be spent sooner rather than waiting until July 1. This is, again, coming from FY13 dollars, so the money would be available.

The first emergency special on this slide involves the Human Services Center campus in Yankton. I am proud that we have a modern first class facility in Yankton that has served patients since 1996. In 1992, Governor Mickelson proposed replacing the out dated and older structures on the Human Services campus with a new facility. That facility was dedicated in 1996 and has been there since, and is a very nice facility. I am sure many of you have been there. Many of the old hospital buildings now unused, and even some farm buildings that date back a century to when the Human Services Center was an operating dairy farm, remain vacant on the HSC campus. Some of these buildings, like the Meade Building, are beautiful historic buildings that we should preserve. But as I said in the Yankton paper last July, many others are in significant disrepair and are well past the point of being remodeled or restored.

Over the years studies have been made because we have been in this condition for two decades. Many studies have been completed to seek other uses and options for the vacant buildings, but due to the outdated structures, poor conditions, and expense of rehabilitating the buildings few viable options were found. Some of the old buildings have been put to reuse. The Pierce Building is occupied as a trustee for the Mike Durfee State Prison. The dietary building remains in use for the provision of food service to the trustee unit. The Kanner Building was remodeled and is the office building for most state agency locations in the Yankton area. If you are going to DSS or some other agency in Yankton, you will go to the Kanner Building on the HSC campus. The campus chapel was renovated and turned into a training center. Some buildings are used for storage, so there are some buildings that are being used. Numerous vacant buildings on the old campus continue to deteriorate. I have personally inspected the entire campus on foot. I've been through every building myself, some more than once, some three times. Many of the buildings have leaking roofs, broken windows, and animals and birds living in them. They are littered with mold, feces, and animal remains.

Last summer, I convened a team to evaluate the old campus and offer recommendations. The team determined that while the land is an asset, the vast majority of the buildings are beyond

the point of repair and have become a liability to the state. Some are attractive nuisances that are dangerous to trespassers.

I support a restoration of the Mead Building, which was the first building at the HSC campus and includes many notable architectural features, including a beautiful Italian marble staircase. Through a partnership with the Yankton Historical Society, we can restore this building and make it an asset for the state and the Yankton community. I also hope that we can save a historic barn, and the Burbank Building.

I propose that the rest of the unused buildings, which are beyond repair, should be demolished. The easy path would be to do nothing. We have done nothing for two decades. The politically expedient path is to hide from that problem. It is time to face that situation. The easy path would be to do nothing, to allow these buildings to continue to deteriorate and fall into disuse, but I propose we turn from the easy path to the responsible path and address a long-developing liability and danger and yet preserve what we can preserve.

Let's look at the remaining emergency specials that I proposed to this year's FY13 budget.

Wildland Fire Suppression: We need to backfill the fire fund for wildland fires that have taken place in the past year. As you know, we cannot predict what the expense will be in this category, so we spend into the red and then we backfill the deficit.

The State Veteran's Home Construction: The general funds will fund a biomass heating unit, which spends more one-time, but will reduce utility costs over the long haul so we can use wood chips. The federal funds are 65 percent of the approved construction package funded by a federal grant which we have been awarded, the largest federal grant in this program. The other funds are South Dakota's 35 percent match and some 100 percent state funded construction. These other funds, the $14 million would represent the maximum amount that we would bond.

Rapid City Wildland Fire Remodel: This is for renovations and improvements of the South Dakota Department of Ag, Rapid City office facility. This is the old Game, Fish, and Parks buildings that were vacated when Game, Fish, and Parks moved into the outdoor Center. The Department of Ag will remodel it for their use. They are being kicked out of the Rapid City airport facility where they are leasing. They are required to vacate by December of 2013.

Department of Military Land Purchase: In Sioux Falls is to purchase land from the city of Sioux Falls. We lease some property, but it is not renewed. We need this land for training exercises, and the Department of Military would like to purchase it. They would also like to use some federal fund appropriation authority to build a motor pool building, again, in Sioux Falls. This would be at the Readiness Center at the Sioux Falls airport. It would be all federal funds. There are currently no vehicles covered from the elements that belong to the motor pool.

The Water Omnibus Bill: You've seen every year since you've been here. This is a yearly appropriation from the water and environment fund, the water pollution control revolving subfund, and the drinking water revolving subfund. It makes loans and grants to local communities for water lines or sewer lines, and you have seen this bill before.

The last item is Inmate Housing at the State Fair: This will provide permanent housing, Governor's houses. They would use other funds that are generated, fair admissions, or camping fees to pay for some Governor's homes that then will be the place where the prisoners stay when they are on site for maintenance.

Now let's look at proposed one-time expenditures next year, FY14.

The first one is a large $4 million appropriation that would fund three separate projects that I am calling Outdoor Heritage Projects. These would be long-term assets for the state. $2 million I am proposing for the Blood Run Nature Area, which is well on the way to becoming a valuable part of our Game, Fish, and Parks system. The funds will develop roads and parking, visitor and day use facilities, offices, and a trail system.

The state of Iowa is interested in dedicating land across the Sioux River from our land, and this has a potential to be the first two-state state park in America. This would enlarge further this nature area and cultural landmark.

$500,000 would be used to seize an opportunity to expand the George Mickelson Trail. The federal government has finally given permission to the state to extend the Mickelson Trail to Mount Rushmore. These funds would begin the development of the 18-mile expansion. Every general fund dollar would be matched with three dollars from other sources.

$1.5 million would be used for a new theatre and visitor's center at Custer State Park. It would be matched by Game, Fish, and Parks other funds and Parks and Wildlife Foundation dollars. Every year, more than 1.8 million visitors go to Custer State Park. The theatre will improve the experience at the Norbeck Visitor Center, and most importantly encourage the visitors to stay longer. This has been something that has been tried in other parks around the nation. By having a theatre that can talk about other things in the park or in the area, you encourage visitors to become interested in those things or aware of those things and either extend their stay or come back again later.

These three Outdoor Heritage Projects total $4 million in one-time spending.

Let's look at other one-time proposals I'm suggesting for FY14.

Pine Beetle Suppression: $2 million. Last year, I asked for $6 million for the Black Hills Forest Initiative. Our pine beetle suppression efforts have already treated over 290,000 trees and partnered more than 700 private landowners. And we have been largely successful, so far, in protecting Custer State Park from the worst of the epidemic. Our fly over map, that I hope you

will ask to see from Game, Fish, and Parks and from the Black Hills Forest collaboration group, shows very clearly that Custer State Park has been largely protected from Mountain Pine Beetles thanks to the hard work that we have been doing. There is still more to be done in this battle against the beetles. I've met with County Commissioners and landowners in the Black Hills, and this year I am recommending an additional $2 million in funds to continue our beetle suppression efforts.

Sanford Underground Lab at Homestake the Ross Shaft: I am recommending $2 million in one-time funds. I spoke earlier about my proposal to create a Ph.D. program in physics at our state universities to support the cutting-edge research that's done at the Sanford Underground Lab at Homestake. I am proposing we spend $2 million in one-time funds to continue to improve and restore the infrastructure at the lab. The funding will accelerate the work that is being undertaken to rehabilitate the Ross Shaft, which is one of the two vertical shafts that give access to the Davis Campus where both of the major experiments that are presently underway are located.

South Dakota has worked over ten years to make the underground laboratory a success. It hasn't been easy, but with the opening of the Davis Campus and the installation of new experiments, things are moving in the right direction. I would encourage every one of you, if you have not gone, to go visit the underground campus on the 4850 level to see the progress for yourself. It is very impressive.

Railroad Trust Fund: I am proposing $1 million be added to that fund which makes loans to companies for railroad projects. We need to support agricultural and industrial development, and one way to do that is by providing loans from the railroad trust fund. Moneys from the railroad trust fund are loaned out for project such as sidings or mainline rail improvements, which have a direct impact on economic development in South Dakota. There are many good worthy projects that would benefit from these funds and this proposal would be a good start.

Tax Refunds for the Elderly and Disabled: This is an annual appropriation for individuals who meet income guidelines.

Physician Tuition: Again, this is dependent upon physicians locating in rural areas, and this repays their medical school tuition in return for their commitment to stay in these rural areas. This pays for two doctors, one dentist, and one physician assistant – repaying their tuition.

Clover Hall Replacement: That's $4 million in other funds, not general funds, but other funds that would replace the current Clover Hall, two-thirds of which has become unusable. The State Fair Foundation, the South Dakota 4-H Leaders Association, and others are leading a fundraising effort to replace Clover Hall. This is an appropriation authority to permit the expenditure of those private dollars on State Fair property.

Conservation Grants: This will use a portion of gas tax refunds that were formerly available. Last year, you changed the law to make those refunds that would be otherwise available for

taxes paid by farmers and ranchers on their property. Instead, the money will now go to, as part of the arrangement last year, make grants to conservation districts to help fight erosion of our soil, lakes, and rivers.

State Treatment and Rehabilitation Academy – the Star Academy in Custer State Park: This would provide for construction of a new maintenance building and also demolition of three buildings, one of which is the old maintenance building and would use available DOC cash.

The new budget bottom line – we've talked about a lot of proposed amendments, and this is what the bottom line would look like in both FY13 and FY14. It shows total proposed revenue and total expenditures in nominal terms, nominal terms.

When the FY13 budget was adopted last March, the Legislature left $16.3 million on the bottom line. Even with the many revisions I am proposing, I've left $16.4 million on the bottom line, and I am offering no proposal to spend it at this time. Similarly, I have also left a nominal surplus of $10.2 million on the bottom line for FY14. Again, both of those numbers represent about 1 percent of the budget for each fiscal year.

Because we live in a time of so much uncertainty, I believe we should wait and see what direction is taken by the President and Congress in the next several months, and what impact it may have on our economy. Congress may fail to reach an agreement on the sequester cuts, and they make take effect. If they do, they will take effect January 2nd. If Congress doesn't reach agreement the expiring tax cuts, the combination of tax increases, with the cuts expiring, plus the automatic sequester cuts, are believe by most economists to create a recession in calendar year 2013. I think we should wait and see what happens on those two fronts. Both of them have deadlines. The tax cuts will expire automatically at the ends of this year unless Congress takes action. So, inaction creates a change. If Congress does not act on the sequester, those sequester cuts will take place January 2nd. Again, inaction will create a change. By the time we reconvene next January, we will know what has happened on those two fronts. We may not know much more if they just simply defer to another date down the road, but it is something that is cause for concern.

One area of great uncertainty I mentioned is the sequester cuts, whether those will come about on January 2nd. Those across-the-board cuts to federal funding could have a significant impact on South Dakota's state budget. Three weeks ago, just three weeks ago, the Pew Center on the States released a report that compared the effect of the sequester cuts on the 50 states.

Let's look at their chart. This isn't my chart – this is their chart. The chart evaluates what percentage of total state revenue comes from federal grants which are subject to the sequester. Our state is at the top. Federal grants subject to the sequester make up 10.3 percent of our state revenue, the highest percentage of any state. The average state gets about 6.6 percent of its revenue from federal grants – South Dakota 10.3 percent. Let's do the math. For FY13, we adopted a budget which predicted state revenue, including general funds, federal funds, and other funds would total just under $4 billion. That's a budget that is already

adopted. You adopted it. Pew is saying the federal grants subject to the sequester make up 10.3 percent of our revenue. That would be roughly $412 million of non-defense grants subject to the sequester. That's not the cut, but that's the total amount of grants subject to the cut. Based on OMB estimates of across-the-board percentage cuts, the Federal Fiscal Information to the States, it is a subscription that we and most states subscribe to, estimate that sequestration would result in cuts of roughly 7 percent of federal nonexempt, nondefense grants to states compared with FY12 funding levels.

This is very rough math, now, but 7 percent would be $29 million to South Dakota. If the cuts take place, our best judgment, now, is they would result in about $29 million of lost federal funds. What happens then? What do you do then? You could do nothing, and let those cuts be felt by the programs that would otherwise depend upon them, or you could replace those cut federal dollars with state dollars. I don't propose one way or the other. I think you need to evaluate that as a policy decision. I am just saying that if the sequester takes place $29 million of federal funds will be cut off – dollars that you included and expected, and put in the budget for the year we are in right now.

Now, there has been some discussion recently that the lame duck Congress will act to prevent sequestration from occurring, and that may be true. But we should be prepared for cuts that ultimately must come, unless taxes are raised dramatically. The federal government cannot sustain current deficit spending, and action must be taken very soon. I just want to emphasize this – I am not being political. I am telling you the numbers are significant, and I am going to show them to you.

Let's understand the breadth of this problem. It is big. Federal fiscal year 2012 just ended September 30th, ten weeks ago. Federal fiscal year revenue was about $2.4 trillion, the green bar. We spent about $3.5 trillion. The deficit for the year was $1.1 trillion, so there's the gap. That red bar if it was stacked on top of the green would equal the height of the blue, right?

The total sequester across the entire nation will reduce spending in the new federal fiscal year, which just began, by about $120 billion. So look at that little tiny cut. That's the sequester including the defense part. That's the whole sequester. This drastic cut that we want so desperately to avoid is just a tiny sliver of what we need to face. This isn't the accumulated debt. This is just last year.

Now, let's put this in some numbers because when we talk about millions, and billions, and trillions my head spins with the zeros. I have to think and count. Let's see a billion is 9 zeros, a trillion is 12 zeros. It's hard to keep track. Let's just cut off 8 zeros, and pretend it's your family. Your son or daughter has just taken their first job at a modest salary of $24,000. That's what they are going to get paid. They're going to get paid $24,000. Then you talk to them and they say I've got a new apartment, I bought some health insurance, I bought a new car, and the car payment. "What are you spending, honey?" you say. "Well, I'm spending $35,000 a year." "Wait a minute. You're earning $24,000, spending $35,000. Oh my gosh, you've got to cut your expenses, or you've got to get another job. You've got to do something. You can't spend

$11,000 more than you're making. Now, probably you're going to have to put some of that money on your credit card until you get this straightened around. What is your credit card balance?" Well, let's look at what the credit card balance would be. The next chart shows the proportion. The credit card balance is $163,000 that your child has. $163,000 is the debt on your child's credit card. Add those 8 zeros and that is our national debt. That's the breadth of the problem. This is our debt on the right, our revenue on the green on the left – $2.4 trillion, spending $3.5 trillion, a deficit of $1.1 trillion, and those cuts are so small that you almost can't see them anymore on this chart.

I tell you that because I don't want to be an alarmist. I don't want you to think that I am being crazy when I say we have to worry about this in the future, because we do. We really have to worry about this. If this were your own personal budget, you would be very alarmed.

Because of all these uncertainties, I think we need to be conservative about committing to future ongoing expenses. Beyond the uncertainty in Washington is another area of uncertainty – the optional expansion of Medicaid under federal healthcare reform.

As you know, South Dakota joined with many other states to challenge the constitutionality of the federal healthcare legislation. Like it or not, that happened. The Supreme Court upheld the law, except for the Medicaid part that was to be mandated. The deal was under the law as written; if you are in the Medicaid program you have to expand. That's the way the law was written and the Supreme Court said "No, no federal government, you overstepped your authority. You can allow and make it optional for the states to expand, but you can't require them to expand as a part maintaining the Medicaid program they are already in." I'm not recommending that South Dakota expand its Medicaid program in our FY14. Our best estimate right now is this expansion would add 48,564 able-bodied adults to the Medicaid rolls. I want to stress that. These are able-bodied adults. They are not disabled. We already cover the disabled. They are not children. We already cover children. These are adults, all of them. There are far too many unanswered questions for me to recommend adding 48,000 adults to the 116,000 already on our roles.

In the first three years, the expansion would be 100 percent funded by the federal government – the claims would be, not the administration, not if other currently eligible people come on. Those would not be covered 100 percent, but all the new people would be covered for their claims 100 percent. That's a lot of the cost in those first years, that's a lot of the cost.

In 2017, the cost changes to 95 percent paid by the federal government, and in 2018 - 94 percent, 2019 – 93 percent, and then by 2020 – its 90 percent federal covered – 10 percent state covered.

The state has just obtained a second round of actuarial studies. In fact, I saw it yesterday for the first time. To understand some of the impacts of the expansion, and our best estimate is the expansion would ramp up to a state cost of between $43 and $44 million additional dollars

by 2020. It would be lower than that, and considerably lower than that in the first few years. But by 2020, we would be spending about $43 to $44 million more in state dollars.

We don't know what will happen after 2020. Will the federal share remain at 90 percent? Will it drop to 80 percent, or 70 percent? Will it drop to the FMAP rate we expect will be at 50-50 at that point? We simply don't know. We just don't know. We also don't know if the expansion is an all or nothing. We know it's not a now or never decision. We can decide not to expand in FY14, which I am proposing we don't expand in FY14. We can still do it in FY15, or we can do it in FY17, or FY18. Whatever the share is on that year, we jump in that share rate. If we jump in 2020, we jump in at the 90-10 rate. We don't start at 100 percent to make it clear. It is not a now or never decision. We don't know if it's all or nothing. That is, do we have to enlarge the expansion to the entire 48, 000 adult population, or can we enlarge to a smaller subset? We are trying to find out the answer to that question.

We need good answers from the federal government, and I have joined many of my fellow governors in asking to meet with President Obama about this. In the meantime, I do not recommend expanding Medicaid in FY14.

Still another uncertainty, our largest economic driver, agriculture, suffered a severe drought in 2012, and we don't know when that will end. The national drought monitor last week showed over 93 percent of South Dakota in severe, extreme, or exceptional drought - the three worst categories. Conversely, 7 percent is not in severe or worse drought – 7 percent. Time will tell what will be the full impact of the drought on our Ag producers, and how it will affect economic activity in South Dakota. Until we emerge from the drought, I think it would be prudent to remain cautious.

Unfortunately, the recession, the uncertainty in the United States, no longer recession, but remaining uncertainty is also seen elsewhere. Last year, Europe slipped back into a recession. This is the first time that Europe has been in recession when the United States has not been. That is something to worry about. Japan is in recession. China's growth is slowing. There are lots of unknowns out there. I don't want to again seem to be an alarmist, but these are global scale things that we can't be oblivious to. So for these reason, I have left significant dollars unspent. I'm hopeful we will know more by the time the FY13 and FY14 budgets must be adopted.

Before we conclude, I want to update you on some other things.

This is our emergency reserve fund. The blue line shows a little history combining the property tax reduction fund and the budget reserve fund. Over the past decade, those funds combined have ranged from a high of $160 million in FY04 to a low of about $87 million last year, after you approved the use of $20 million for emergencies – the floods, the fires, the mountain pine beetles.

We ended FY12 with a nominal surplus of $47.8 million so we are able to restore the $20.2 million and add another $27 million - both what we spent and still more. Our reserve balances today total $134.7 million.

If you choose not to spend the $16 million I left and you left on the bottom line for FY13, and that went in the reserves, it would go up to 11.9 percent of our spending rather. If you didn't choose to spend the other $10 million for FY14 that went to the reserves, it would end up with a balance of $161 million, about where we were in FY04. I am not suggesting you should do that. I am just saying that's what would happen.

A report by the Center on Budget and Policy Priorities is shown on the green line. They recommend reserves should be maintained at 18 percent of general fund expenditures. Again, that's a policy decision. That's a good thing to debate. I am not suggesting it's the right thing to do or the wrong thing. I am just offering it as a benchmark.

There aren't many states today that can consider how large should be their reserve funds. That's something that should make us all very proud.

In my inaugural address almost two years ago, I said that South Dakota could show our sister states, and even our federal government, that there is a better way. This year, we are considering a balanced budget for the 124th year. We have strengthened our balanced budget requirement with a constitutional amendment. We have replenished our reserve funds after the flooding, fires, and pine beetle emergencies. We're preparing for federal sequester cuts. We have avoided raising taxes. We are improving our financial practices. We are even working to upgrade our credit rating. And, Barron's has recognized South Dakota as "The Best Run State in America."

I want to thank you for your public service. To those legislators who are not returning, I thank you for your work for our state for these past two years, and years before. I know many others in this state join me in thanking you for participating in this great representative government. To those legislators who are returning next year, and to the new legislators who will join us, I ask for your continued diligence in the face of an uncertain future. We can face with that future with courage, with the knowledge that our predecessors have left a strong South Dakota in our hands. In South Dakota, we know we can't spend and borrow our way to prosperity. We understand you can't think about today's benefits without being concerned and considering tomorrow's consequences.

In South Dakota, we know that have to keep our state structurally sound for the future. That's my focus this year. I hope you'll join me in that focus. It's our duty to the people of South Dakota, and I thank you for your attention.