



BUDGET ADDRESS OF GOVERNOR DENNIS DAUGAARD

THE STATE CAPITOL – PIERRE, SOUTH DAKOTA – DECEMBER 6, 2016

Thank you very much and welcome. Today I offer a proposed budget for Fiscal Year 2018, but before I do that I'd like to say a special thank you to the Bureau of Finance and Management for their hard work in a difficult year. Please help me thank them. Would you stand, BFM employees, and let us thank you.

Today I'm going to review the state's economy; I'll look at current year revenues and expenses, and offer my proposals for next year.

As you know revenue collections have been running below collections, but happily expenses have also been lower as well. Although ongoing expense savings do not bridge the gap created by weak revenues, one-time revenues and one-time expense savings can provide that bridge. By next year we should have gained enough revenue growth to cover ongoing expenses for FY2018 so we have structural balance.

But let's begin with a look back. Over the past five years, we have posted a budget surplus at the end of each year. Let's take a look at that.

As you can see, the surpluses have been rooted in both revenue better than projected and expenditures less than appropriated.

The red parts of each bar depict spending at less than appropriated levels. These have been fairly stable, in the \$7-\$13 million range. Most reversions have been in our entitlement areas, predominately in Medicaid, however last year we saw reversions in almost all agencies.

The blue parts of each bar depict revenue received above expectations. Over these past years, we have worked together to adopt conservative revenue estimates, with a high probability of attainment. FY2016 ended with revenue slightly above levels adopted last March.

With these surpluses we've improved our rainy day fund balances and invested in one-time opportunities. Let's see how these surpluses have affected our rainy day funds.

Since I've been Governor, we've added over \$117 million to our rainy day funds, of which we've spent about \$67 million for disasters and debt reduction. This chart shows the balance of our rainy day funds as a percentage of our budget.

Since the early part in the graph – FY09 through FY11 – you can see we've maintained reserves at or above 10% target of our general fund appropriations. Nationally, the median state rainy day fund is about 5%, with half the states above that and half below 5%.

Today in South Dakota we have \$157.4 million in our rainy day funds, or about 9.8% of our target goal. We have to remember that last year we increased our budget substantially in to increase teacher pay. As a consequence the rainy day funds as a percentage of that a larger budget has fallen slightly to 9.8%. My recommendation for FY2017 is to replenish rainy day funds to a 10% level, using \$2.4 million. I'll describe how I propose we do that, but before further budget recommendations, let's take a look at some economic trends.

The South Dakota Council of Economic Advisors regularly meets to consider a wide range of economic forecasts and assumptions that are used in predicting future tax revenue. Reviewing this information with experts from across the state helps us provide the best economic and revenue forecast for the budget each year. Let's take a look at some of the key economic assumptions and forecasts that are used.

First at the national level, like other governments we start with national economic indicators.

IHS Economics' most recent forecast is for 2.2% Gross Domestic Product growth for 2017 and 2018. Our South Dakota Bureau of Finance and Management reviewed this forecast with the South Dakota Council of Economic Advisors, and it was judged to be consistent with their views for the U.S. economy, but needed slight moderation specific to the South Dakota economy.

The moderated forecast is closer to recent South Dakota trends for employment and income growth. This moderated forecast was used to develop the revenue projection I'm presenting to you today. We expect positive economic growth, but at slow, stable rates, similar to what has been experienced the past few years.

Inflation is also another important variable, as inflation has a direct impact on the growth of our sales tax. Higher inflation creates stronger growth in sales tax revenue, but lower inflation as experienced the past two years, leads to slower growth in sales tax. Inflation is anticipated to be in the 1.5%-2.5% range over the next two years, more normal than the extremely low inflation we have recently experienced.

We're assuming no major economic disruptions from abroad, and in South Dakota, we expect steady housing and construction activity over the forecast period.

Finally, as most of us are aware, we anticipate farm income to be at lower levels compared to record highs we experienced a few years ago. Agriculture is a major cornerstone of our state's economy. Continued low commodity prices combined with sticky input costs have put pressure on farm income as you know. We anticipate this will continue in 2017 and 2018, and this leads to less spending in the agriculture sector, and lower sales tax collections.

This next group of graphs shows IHS Economics' most recent forecast for the U.S. economy, these are national predictions using four key indicators. The grey bars show calendar years, not fiscal year, actual figures and blue bars show the forecasts for those years.

The first chart, top left, shows U.S. Real Gross Domestic Product in trillions of dollars. Real GDP is considered the most comprehensive measure of the U.S. economy. Real GDP was flat during the recession years, and since then, it has grown about 2.1%, slower than the 3.0% growth rates seen before the recession. IHS Economics forecasts more than \$17 trillion of real GDP in 2017 and 2018, at growth rates of 2.2% each calendar year.

The top right chart shows U.S. employment. The U.S. economy lost about 8.7 million jobs during the recession and it was nearly 7 years after the recession began that those jobs were recovered. The job growth forecast for 2017 and 2018 is 1.2% and 0.9% growth in U.S. employment.

The bottom left chart shows millions of U.S. housing starts. As many of you may recall, the sharp drop in housing was one of the causes of the Great Recession. Housing starts are anticipated to continue to recover at a steady rate throughout 2018.

The bottom right chart shows the U.S. Inflation rate. After nearly zero inflation in 2015, 2016 is forecast to end at roughly 1.3% inflation. Inflation in 2017 and 2018 is projected at 2.5%.

Next, we'll consider four South Dakota specific economic indicators – employment, nonfarm income, housing starts, and unemployment.

These South Dakota economic forecasts were used to develop revenue forecasts for fiscal years 2017 and 2018. Remember, these forecasts were moderated slightly, from what IHS Economic suggested after we consulted with the Council of Economic Advisors here in South Dakota.

First, top left, South Dakota employment. During the recession, South Dakota did realize job losses, but only at about half the rate of the U.S. economy. We recovered those jobs more quickly than the nation, and continue to grow our employment. In the most recent several months of 2016, our monthly employment number was growing at 2% or more, year-over-year. We anticipate continued nonfarm employment growth in both 2017 and 2018, albeit at a slower rate of growth.

Next chart, top right, South Dakota nonfarm income. South Dakota nonfarm income is forecast to grow 4.2% and 4.7%, in 2017 and 2018, these are near historical rates.

Bottom left is South Dakota housing starts. They have grown strongly thus far in 2016 as you can see on the graph, but are expected to moderate to lower levels in 2017 and 2018, closer to 4,000 starts per year which is more typical.

Last chart, bottom right is South Dakota unemployment. After levels of 5.0% or worse during 2009 and 2010, our unemployment rate has recently declined to lowest in the nation. We project it to be around 3.0% over the next two years.

Bottom line, the moderated forecasts project continued steady but slow growth in South Dakota's economy. We should continue to be conservative in economic and revenue forecasts as we have done in the past.

Now sales and use taxes make up over 60% of our general fund revenue. It is by far our most important revenue source. It can be volatile though, month-to-month, and it's important to track sales taxes as we make budget decisions. Let's look at some trends we have been seeing in the sales tax.

This chart has monthly data, back to the start of calendar year 2000. We show in this chart 202 months of data, through October of 2016, just a month ago. The shaded areas represent economic recessions in those two areas.

This chart shows growth of taxable sales by month, comparing a given month to the same month, one year earlier. As you can see, even during the slow steady growth we've experienced since the recession, we've had months when taxable sales were lower than the same month one year earlier. You can see that in almost every year. In some years the blue line dips below zero, that might mean that month was compared to the prior year, same month, was lower in terms of sales tax collections. For example, in August 2016, we had taxable sales that were more than 7% lower than August 2015. Growth rates for taxable sales can be very volatile from month to month.

Adding a 12-month moving average makes a recent downward trend a little easier to see, which is represented by the red line. Notice the highlighted portion on the right side of the chart, since mid-2015 we have been seeing a noticeable slowdown in the growth of our taxable sales. Remember that this red line is still above zero. It still shows growth, albeit slower and slower growth.

This gives you a perspective of the longer term trends in sales tax, now I'd like to review more recent sales tax collection data.

This chart shows the monthly growth numbers in bar chart form. The leftmost three-quarters, left of the line, shows FY2016 sales collection growth by month. The first two bars, July and August 2015 shows sales taxes had strong growth in July 2015 and 2016, when compared to the prior year July and August. That's when tourism was very strong – the Sturgis Rally was celebrating its 75th Anniversary. September and October were weak, then November and December were on target, then weak collections January through May.

June of 2016 was pretty strong, and we believe this is influenced by those who saw the sales tax increase coming, and bought early, which shows up in June collections.

To the right of the black vertical line, we see the first four months of the year we're in right now FY2017. As you can see, we saw not growth, but shrinkage in July and August sales. Remember two charts ago we've seen a month or two below zero almost every year, so a few months below zero does not a trend create.

Again though, we think this is partly influenced by a more normal tourism year, and a more normal Sturgis Rally, and course loss of sales which had been made in FY2016 to beat the sales tax increase.

Now, we have added the green dashed line; this represents the growth needed to meet the Adopted sales tax estimate when you adjourned in March. In FY2016, revised sales tax estimate needed 3.6% growth for the full fiscal year to meet the sales tax estimate.

Adding the year-to-date growth rate represented by the red line shows we finished the fiscal year 2016 with just 2.9% growth or just a shade less than was needed to meet the revised FY2016 sales tax estimate. Now remember this is just sales tax, it's not total revenue. Our total revenue did meet our target – a little bit better than target – but in terms of sales tax we did not meet our target. Even though we missed the sales tax mark, we beat estimates in other taxes, and ended with total tax revenues slightly above total tax estimates.

Still, because we finished last fiscal year lower in sales tax collections, it pushes up the growth rate needed in FY2017 to meet the Adopted FY2017 estimate because we are starting at a lower level.

Looking at the far right side of the chart, you can see the 4.5% growth rate needed to meet the Adopted FY2017 sales tax estimate. And through these four months, we have seen year-to-date shrinkage in sales of 2.5%. Sales down 2.5% so far this fiscal year for those four months. We see weakness in the ag sector as one factor in this shrinkage so let's look at that.

This chart compares net farm income to sales tax on farm machinery. The blue bars use the blue scale to show South Dakota net farm income. Look at 2002 and 2006. See the low income during those drought years. Look at 2008 and later. Income is strong, with high crop prices and big harvests. 2012 was a drought year, but crop insurance locked in spring prices which were still high. In 2014 and 2015, farm income dropped and is expected still lower in 2016. That's the story of the bars.

What does this mean to our budget? The red line and the scale on the right estimates farm machinery sales tax collections. As you know, in South Dakota, many purchases by ag producers are exempt from sales tax, but sales and use tax does apply to farm machinery. So if you look at 2007 and later, you can see tax incentives and strong farm income fueled strong machinery purchases.

Sales taxes here grew from \$17.4 million in FY08 to nearly \$45 million in FY14. This boosted our tax revenue during those years. Now we see fewer farm machinery purchases, which means

less sales tax. Since the peak in FY2014, sales on machinery has dropped more than 50%. Lower net farm income means less farm machinery sales tax income.

This suggests growth in total sales tax will be below average, until farm income and equipment purchases level out.

What are some of the factors that are playing into the recent sales tax weakness?

Well as we just saw, ag equipment spending has been weak, that's one factor. Low inflation we have experienced recently is providing little price increases which generate in return tax increases. As I mentioned, we had a slower year this year in tourism, compared to a record year in 2015.

In general, consumers are expressing overall caution in spending due to uncertainty, whether it be political uncertainty preceding the election or uncertainty about the future of the economy.

Finally, online purchasing continues to erode sales tax collections. Online spending in the United States has grown by more than 12% each year for the past seven years. Understand, many online retailers do collect and remit sales tax on purchases by South Dakotans. However, many do not pay. Under current federal law, an online retailer is not required to collect and remit sales tax to South Dakota unless they have a physical presence in South Dakota. Thus the burden to pay the tax falls upon the individual purchaser, and in most cases, those sales do not get reported nor any tax paid. Let's look at some examples to be sure we all understand this.

All on-line sales are taxable, however, not all companies are required to collect and remit the taxes. Three scenarios illustrate who is required to remit taxes and who is not.

Let's look at the first one, in scenario #1; a consumer goes shopping at a Best Buy store in South Dakota. As a result, two things happen. First, the consumer purchases their product. Second, Best Buy collects and remits the sales tax of that purchase to South Dakota.

In scenario #2, a consumer shops from South Dakota, but on-line and makes a purchase at bestbuy.com. As a result, two things happen. First, the consumer purchases their product. Second, Best Buy collects and remits the sales tax of that online purchase to South Dakota, it doesn't matter that an on-line purchaser connected to a website in Minnesota, it doesn't matter that the warehouse that shipped that product is in Minnesota, and the important factor is that Best Buy has a fiscal presence in South Dakota. So whether the person walked into the store and bought it or bought it from Best Buy on-line, Best Buy collects the tax and remits it to South Dakota.

In scenario #3, a consumer shops from South Dakota, on-line and purchases from a company which does not have a physical presence in South Dakota. As a result, two things happen. First, the consumer purchases their product. Second, this company with no physical location in South Dakota does not collect or remit sales tax to South Dakota.

The lost sales tax revenue to state and local government, in examples like scenario #3, is estimated at roughly \$50 million to state and local governments. Consumers should pay use tax if they did not pay sales tax, but few do. We receive roughly \$4M from remote sellers who voluntarily collect the sales tax. This means most is not being received.

As you know we have been actively addressing this for several years, but most recently in the 2016 Legislative Session. The Legislature passed, and I signed Senate Bill 106. This legislation requires remote sellers with no physical presence in South Dakota to collect and remit sales tax in on online purchases. It directly confronts the *Quill* Supreme Court decision. This legislation initiated litigation and is now working itself through the court system. Together, we are addressing this critical issue on many fronts.

With all that background on economic conditions and our sales tax, let's take look at the full revenue picture, including the revisions for the current year, FY2017, and estimates for FY2018.

This chart details the revised forecast for this year, FY2017, for the ongoing receipts. The left hand column of numbers shows the adopted figures you and I agreed upon last March, totaling \$1,598.1 million, the next column shows the revisions as of today. Sales and use tax is revised lower by \$32.0 million, and we discussed at length the reasons for that. Lottery has been revised higher by \$1.1 million; this includes instant, online, and video lottery receipts to the general fund. Video lottery is currently running 3.4% higher than a year ago. Contractor's excise tax has been revised higher by \$2.0 million. Stronger collections so far in FY2017 are due to healthy construction industry, you saw that in the bar charts of construction housing starts. Insurance company tax – up \$3 million as collections finished FY2016 ahead and we anticipate continued growth in FY2017. Unclaimed property revenues are revised \$1.0 million lower due to higher claim payments realized so far this fiscal year, and the remaining revisions roughly offset each other. Total ongoing receipts are \$1,572 million which is \$26 million lower than the opted forecast, all driven by weaker sales and use tax.

Now let's look at FY2018 projected revenue which adds another column of numbers to those we've been looking at. This chart adds that recommended FY2018 ongoing receipts for each category. The far right column shows the change, in millions, as compared to the FY2017 adopted estimate.

Look at sales and use tax, starting on the left. \$1,006.7 million was the adopted FY2017 estimate. \$974.7 million is the revised estimate today. Next, in FY2018, I am recommending a forecast of \$1,013.1 million for FY2018. The increase of \$6.4 million shown on the far right column is compared to the FY2017 adopted figure, in other words we think revenue will be lower, it will reach the adopted estimate and then exceed it by \$6 million by the of FY2018. This number represents the new sales tax we have to budget expenses against for FY2018 in the sales tax area.

Looking at each of the revenue sources on the right, we see some growth in larger sources – lottery, contractor’s excise tax, insurance company tax, and the two that are slightly lower – unclaimed property and tobacco taxes.

In total, for FY2018, I propose a revenue forecast of \$1,617.8 million. This is \$19.7 million higher than the adopted FY2017 forecast, meaning for FY2018 we’ll have \$19.7 million in new ongoing revenue for the FY2018 budget.

Now let’s consider proposed expenses against that \$19.7 million. The Consumer Price Index-W, which is used as a benchmark for education spending, was 0.3% for the year ended June 30, 2016. However, my proposal is to increase K-12 education and technical institutes by 1.0%.

My proposal includes a 1.0% increase for all providers. In addition to this, last year I proposed and you adopted a three year plan to improve the rates of Medicaid providers who are below 90% of costs. This budget completes year two of this plan.

For state employees I am proposing a market adjustment of 1.0% and I’m proposing to put pay for performance on hold until next year. These increases are affordable only because we are seeing reduced expenses in some areas.

The Federal Medical Assistance Percentage, or FMAP, increased by 1.13%, reducing the state’s share of Medicaid expenses. We have also closed the STAR Academy and successfully transitioned all juveniles to private placement. The sale-leaseback program has been completed, and finally, utility usage and prices are projected to be lower.

Let’s look at the dollars, we’ve looked at percentages, but look at dollars involved in these four areas. For education, total increases of \$6.4 million, that includes 1.0% increase for state aid and an increase of 1.0% for technical institutes.

Medical services and provider assistance – \$9.3 million, this includes increases of \$18.8 million, offset by \$9.5 million decreases in FMAP savings, for a net increase that you see here of \$9.3 million. This again provides a 1.0% inflationary increase to providers and year two of the three year plan to bring all providers up to at least 90% of costs.

Under state employee compensation a 1.0% market adjustment, as well as addressing some pay range minimums, which I will speak about in a minute. No pay for performance.

The remainder of state government -- a decrease of \$2.3 million. This offsets increases related to correctional healthcare and establishing a mental health court, against larger decreases related to the sale-leaseback program, netting to a decrease of what you see here \$2.3 million. So the total of \$19.7 million matches the new ongoing revenue we just saw in a prior slide. Now before more detail on these four major categories, I want to talk now about Initiated Measure 22. I recommend no funding for Initiated Measure 22 in FY2018. As written, IM 22 appropriates \$9 per voter from general funds, every year, starting in FY2018. Nine times

544,000 registered voters means nearly \$5 million, every year. With only \$19.7 million in new revenue, this would cannibalize approximately 25% of it. Already minimal 1% increases just proposed – for education, Medicaid providers, and the state employees – would need to be reduced to only six-tenths of one percent.

I believe it's not responsible to use taxpayer money to fund political campaigns at the expense of education, and I am certain the voters of this state do not support that.

Ballot measures are of course “take it or leave it” – voters can't amend them or vote for part of them. IM 22 had 70 sections and 14,000 words. I was reading it to you today it would take me an hour and a half to recite it to you. It is our obligation, at the least, to correct its obvious errors that make it unworkable.

Unfortunately, in this case, that's a big job. This is easily the worst drafting I've read in my 20 years in coming to the Capitol. It's vague, overbroad, and it used undefined and inconsistent terms. This sloppiness leads to an endless number of bizarre unintended consequences.

The voters certainly didn't intend to make a registered nurse at McKennan Hospital a criminal because her husband is in the state legislature. They didn't intend to discourage school administrators who host legislators from offering sandwiches and chicken wings. And they don't want us to cut funding for schools or nursing homes to pay for campaign commercials.

As Greg Belfrage of KELO radio said: “I'm not blaming voters. They were hoodwinked by scam artists who grossly misrepresented these proposed measures.” The backers of Initiated Measure 22 knew about many of these problems before they began to circulate petitions. We know because the Legislative Research Council told them in writing that some provisions were likely unconstitutional.

But financial backers of IM 22 are out-of-state advocacy groups. Ninety-eight percent of the funding for IM 22 came from out of state, over \$1 million from Massachusetts. The drafters ignored the constitutional questions and moved ahead with this deeply flawed piece of legislation. They are not South Dakotans, they don't live here, and they don't have to deal with the consequences of their actions.

Instead, they promoted this measure with a deceptive campaign. Their ads, and you saw them, portrayed the hand of a well-dressed man holding out a handful of cash, as if the cash is being handed to an elected official.

In all my years of public service, I have never heard even a hint of an allegation of any elected official taking a bribe. Never. The proponents of this measure never alleged even one instance that would have been prevented by this act. And as news reporter Bob Mercer wrote, they failed to mention that bribery is already a crime. In fact, we have an entire chapter of the criminal code, chapter 12A, which deals exclusively with bribery of public officials. It's already a

class 4 felony. The proponents of Initiated Measure 22 owe an apology to the many honest public servants whose reputations they have besmirched groundlessly.

More importantly though, they owe an apology to the people of this state. They told voters there was a problem and this act would solve it. But it's their sloppiness and careless disregard for the laws of our state that have created a morass of problems. Voters were asked to pass judgment on a 14,000-word bill based on a 200-word explanation and deceptive 30-second commercial.

As elected officials, we also owe the citizens something. We must respect voters' intent. They expect us to have a campaign finance system that is transparent, and honest, and they expect lobbyists to use only their arguments to win our votes.

I hope this session we will do the difficult work that the backers of IM 22 failed to do. We will not slap together a sloppy 14,000-word bill, without regard to the consequences, without explaining the problems that it could cause. Instead, we will study these issues with care and work together to find solutions, soliciting feedback from all perspectives. We will think through the consequences of our actions and ask the most talented legal minds to help draft better legislation.

Now, let's return to the proposed FY18 spending proposals, looking at each of the major areas in more detail.

First, education – State aid to education as I mentioned will total \$6.4 million that's made up of State Aid Education that includes 1.0% inflation in general K-12 education. This increases the targeted average teacher pay to \$48,985 for FY2018. Said another way, it gives schools enough money so that if they maintain the right student-to-teacher ratio their average teacher pay can be \$48,985.

Board of Regents M&R – \$919 thousand. Several years ago I proposed and you adopted a plan to bring maintenance and repair budgets to 2% of the replacement value of our state buildings over the course of four years. We reached this goal in the FY2017 budget. This funding is to maintain the 2% budget, and this number is particularly related to Board of Regents facilities.

South Dakota Scholarship – \$413 thousand. This funding proposed allows students to receive a \$6,500 award over four years. This funding helps keep the scholarship competitive as an incentive for students to take a rigorous high school curriculum and stay in South Dakota for college. Over 4,000 recipients are projected for the coming school year.

The Board of Regent utilities fund – a decline of \$2.6 million as a result of lower fuel prices and utilization, utility expenditures at the Board of Regents are projected lower.

Then there are miscellaneous increases and decreases which total and increase of \$848 thousand. All those add up to the \$6.4 million seen in the prior chart.

Now medical and provider assistance – Growth and utilization is identified as costing us \$6.3 million. We project an additional 1,166 persons will enroll in Medicaid. That's 1.1% growth.

Mandatory inflation of \$5.5 million – These inflationary adjustments are required by the federal government and vary across services, such as Medicare and certain federally qualified rural health clinics.

Provider inflation at 1% – This supports providers such as nursing homes, community support providers, physicians, and many others.

Provider enhancement to 90% will complete year two that will cost us \$709 thousand. As stated earlier, last year I proposed and you adopted a plan to increase all provider rates to get them to at least 90% of their costs over three years. During the 2016 Session, additional funding was appropriated to provide half of year two, so we did a year and a half last year and in FY18 I propose we complete year two funding for this plan.

State savings due to the FMAP increase in 2018 the FMAP is increasing 1.13%, so our state's share goes down by that amount from 45.89% to 44.76%. This means in FY2018 state general funds for every dollar of Medicaid expense state general funds will pay \$44.76 of it.

Miscellaneous increases and decreases of \$1.98 million, this includes other changes throughout the Departments of Social Services, Health, and Human Services such things as rural family residency track and court-ordered mental health treatment.

The third major category is state employee compensation. The first line is the salary increase of 1.0% for permanent state employees cost \$3.7 million.

Then a pay range minimum improvement of \$780 thousand is to move the pay range up for low-paid, frontline people who are doing difficult but important work, a number of these employees being paid between \$20 thousand and \$30 thousand. I think we need to continue to get their entry level pay at least up to the level that it needs to be. Some examples of jobs in these pay grades include:

- Mental Health Aides at the Human Services Center in Yankton,
- Direct Support employees at the SD Developmental Center in Redfield,
- and Family Services Specialists in the Child Protection program.

And finally health insurance – In recent years we've been fortunate to see minimal growth in our self-insured health plan, this \$1.8 million cost is a consequence of working to encourage wellness and early detection of health issues. And for FY2018, I am recommending an increase in the health insurance rate of \$342 per benefitted employee. The total increase as you can see is about \$6.3 million.

The fourth number shown on an earlier chart is a net of increases and decreases and here's the detail on that. First correction healthcare we're projecting costs are going to be up \$2.9 million.

This includes addressing the federally required healthcare needs of our inmate population, as well as contractual and inflationary increases.

Drug, DUI, and mental health courts – \$475 thousand. These courts continue to be a successful alternative to incarceration and have helped to reduce recidivism. This funding addresses operational costs throughout 14 drug and DUI Courts in the state and establishes a mental health court in Pennington County.

The State Treatment and Rehabilitation Academy, STAR Academy – cost reduction of \$3.8 million. Fewer juveniles are being committed to the Department of Corrections. This is a trend we've seen over multiple years and those commitments are placed in private care rather than at STAR Academy. And a consequence of that is we were able to close STAR Academy earlier this year, so net costs are projected down in 2018 by \$3.8 million.

The fourth item is sale and leaseback a decline of \$4.3 million. In the 1986, we sold most state-owned buildings in the capitol complex and leased them back for state use – this was during Governor Janklow's administration. From the proceeds of the sale, an annuity was purchased, whose income stream matched the lease payment, so we got income payments in, paid the lease payments out and one off-set the other being revenue neutral. The interest rate differential at the time provided a one-time lump sum of money to the state that was spent; it was essentially an arbitrage transaction. The last lease payment and last annuity payment both occur in FY2017, so the annuity payment does not appear in our revenue projections, nor should the lease payment appear in our expense projections. Remember, the ending annuity payment reduced the revenue projection shown earlier, so it's a net zero impact.

The miscellaneous increases and decreases on the fourth line \$2.4 million. Bottom line is a net decrease in FY2018 of \$2.3 million from a variety of sources.

This chart now shows all of the increases and decreases from the previous slides. The net increase in expenditures of \$19.7 million, which matches the projected FY2018 revenues.

Now that we discussed the proposed FY18 budget, let's discuss the changes we need to make in the current year to balance. First we start in the hole, because revenue is weak. Then as I described in the FY18 budget discussions, we have expenditures, right now, which are expected to be below 2017 appropriations in several areas. The total amount is \$34.7 million, and now let's discuss these items in more detail.

Here are the reductions. First State Aid to Education – \$20 million. This decrease is due to several factors. One, the actual number of student enrollments, compared to what was estimated, is lower by about 1,400. We're still seeing student growth, but it's much slower than we thought it would be. This combined with higher property tax values, which are partially offset by a shortfall in special education, accounts for \$2.3M in the decrease in state aid expenditure need. Second, as part of education funding package that was passed during last year's session, you'll recall that \$36 million of the tax increase dedicated property tax relief.

As you know, property taxes are paid on a calendar year basis, and the state budget is on a fiscal year basis. Consequently only half of the \$36 million is needed for property tax relief in state fiscal year 2017 which allows \$18 million to be reduced on a one-time basis in the current year. We'll need all \$36 million of it in FY18, but we only need half of it FY17 and that provides the \$18 million added to the other two, for a total of about \$20 million savings in state aid to education.

The Department of Social Services is next – they're showing utilization. Much of this is related to slower ramp-up of juvenile justice reinvestment costs, the same amount of money is going to be spent in juvenile justice reinvestment but it is slower in ramping-up so as we get to the end of FY2017, we probably won't have spent as much as we projected to have spent in the 2017 Fiscal Year, and we also have fewer eligibles than budgeted within the Department of Social Services.

The third item I mentioned already once, STAR Academy. We discussed earlier the reductions in FY2018, this is the amount is what can be reduced in the FY2017 budget as a result of the closure happening earlier this calendar year.

Utility rate adjustments again as I mentioned in FY18 were seeing the same sort of utilization and cost levels decreases so we were able to cut \$3.5 million in general funds due to reduced costs and lower usage in the current year utility budgets.

The technical institutes' lower enrollment – we'll save about \$700 thousand as a consequence of that.

All told reductions are \$34.7 million. Some of them are one-time reductions that will not carry into reduced expenses and then in 2018 we need to have them in the 2018 budget but they are available in 2017. So that tells two of the numbers that are going to be available to us in 2017.

Again, we start in the hole, with \$26 million in weak revenues, under water, and then the lower expenses I just detailed more than offset that revenue weakness. And there is a third one-time revenue we can create, if you agree with my proposal.

Under current law, we receive a considerable amount of cash from unclaimed property. These dollars are primarily from unclaimed bank accounts. We receive those funds as cash in late October or early November, but when South Dakota receives stock which is unclaimed property, those stocks must be held under current statute for different amounts of time before we can sell them. Depending on the stock, the state may have to hold the stock for a year or possibly three years before they're sold. This situation places risk on the unclaimed property office as they exercise discretion following those statutory periods, deciding when stocks can be sold.

I am proposing legislation that would require unclaimed stocks to be converted to cash before transfer to the state as unclaimed property. This would reduce risk to the administrator,

simplify our comprehensive annual financial report, and allow the state to sell the existing unclaimed stock portfolio that has accumulated over several years. This would result in a one-time increase in revenue of \$13 million as you can see.

Another offset to our revenue shortfall can be foreseen in reversions we know now will occur this year, in the Unified Judicial System rural attorney recruitment program and in criminal justice investment. Those two combined are just over a \$1 million, so all told these various sources are able to offset the shortfall in the current year and actually result in \$22.7 million of one-time funds, nearly \$23 million, available in FY2017.

Here is my proposal of where these dollars can be invested.

First, replenish reserves to 10% – Last year I proposed and you agreed with transferring funding from reserves in excess of 10% and spending on one-time priorities. My proposal is to transfer \$2.4 million back into the reserves to achieve the 10% level.

Second, the State Animal Disease Research and Diagnostic Laboratory – \$5 million. This funding is to construct an addition to South Dakota's ADRDL, as well as to renovate the existing facility. I will discuss this in more detail in just a moment.

Third item, Fire Suppression Fund – this is to backfill the fire fund for wildland fires that have taken place in the past year.

Spearfish Canyon – \$2.5 million. As you know, Congress is considering legislation that would transfer lands near Spearfish Canyon to the state, for use as a state park. The proposed land swap would trade federal Black Hills forest land with lands held by the state Commissioner of School and Public Lands. If Congress approves this trade, the state would need to buy this land from the School and Public Lands trust so we can use it in the trade. And the \$2.5 million would be the funding going to School and Public Lands for that purpose. Even though Congress has not yet approved the swap, I'm asking you to approve the funding this year, so if Congress approves the legislation, the state can act.

Correctional Healthcare – \$1.8 million. This funding addresses the shortfall seen within the Correctional Healthcare budget.

University of South Dakota Law School – \$1.2 million to be used over the next three years. We have seen a nationwide decline in applicants for law school which is leading to smaller class sizes at the law school. This will help the law school meet curriculum and library requirements for the next three years.

Extraordinary Litigation Fund – \$1.0 million to backfill the Fund, for litigation expenses not covered by the Public Entity Pool for Liability or the PEPL fund as it's known.

DOC security and operations – \$908 thousand. This funding allows the Department of Corrections to upgrade needed security equipment.

Rural recruitment assistance – \$843 thousand. This will continue our program many of you are familiar with, to attract healthcare professionals in rural areas. The funding will pay for three physicians, one dentist, one physician assistant, four nurse practitioners, and many other healthcare professionals such as pharmacists, physical therapists, and nurses who have agreed, served time, and been employed in rural areas.

Veterans Home – \$830 thousand is to address Medicaid eligible beds at our State Veteran's Home. There is a corresponding increase in general fund revenue, and this is a net savings to the state.

And there are miscellaneous remaining one-time expenses of \$2.9 million this number includes appropriations for the Joining Forces Initiative within the Department of Veterans' Affairs, HOPE Court incentives within Unified Judicial System, and \$400 thousand to make changes to the Statewide Automated Victim Information & Notification System, SAVIN, which we must undertake to comply with Marsy's Law.

Now I mentioned earlier the \$5 million I am proposing spending on the State Animal Disease Research and Diagnostic Laboratory. Let's look at that in a little more detail.

The State Animal Disease Research and Diagnostic Laboratory is South Dakota's animal health laboratory, located on the SDSU campus. Its purpose is to provide critical research and diagnostic support to protect our citizens and livestock industry from disease outbreaks. With recent animal disease epidemics like P.E.D virus in swine and avian influenza in poultry, this lab has demonstrated the value of quickly and effectively diagnosing and responding to these outbreaks.

The current laboratory was built in 1967 and upgraded in 1993. It is out of date and needs to be modernized to correct aging infrastructure, accommodate new technologies, and meet current and future standards.

During the 2016 Session, the legislature approved funding for a comprehensive design study, and this study provided more confidence in the total cost estimate.

The initial upgrade and expansion estimate by the architect was a total project cost of \$68.8 million; however, after additional planning and several months of reviewing potential costs and seeking efficiencies, we were able to reduce the remaining total project cost to \$58.7 million.

SDSU is able to contribute \$6 million towards this project. My proposal includes \$5 million in state one-time funds, plus \$1.5 million of offsets on the operations side, leaving \$46.2 million left to fund.

This project can only come together with significant participation from the ag industry. Over the next month, we should continue to work with ag industry leaders to find a means to fully fund this necessary project. If such a means cannot be found, this appropriation would not be necessary this year.

So, this chart now shows the on-going and one-time general fund expenditures. The FY2017 adopted total budget last March was \$1.598 billion. As a result of the softened FY2017 revenues, the FY2017 revised on-going expenditures have been reduced to \$1.569 billion. Because of one-time impacts that I talked about earlier, we are able bridge the gap in key expenditure areas in FY2017 and need no other budget cuts in spite of weaker tax revenues. So the total adopted budget is \$1.598 billion. The amended proposal for FY17 is \$1.583 billion. And the recommended budget in the general fund for FY18 is \$1.617 billion.

In total, I am proposing a revised budget in FY2017 of \$4.7 billion and recommending \$4.6 billion in total spending in FY2018.

In addition, my proposal reduces Full Time Equivalent's by 38.4 FTE from the FY2017 adopted budget, a total now of 13,862.0 FTE's.

Both years are honestly balanced, with ongoing expenses for FY18 fully supported by only ongoing revenue.

South Dakota is working – working better than many other states. We can proudly say that we've balanced our budget, honestly, every single year will out gimmickry or over borrowing. Next year will be our 128th year.

We prudently maintained a 10% reserve of rainy day funds, using excesses to address emergencies and prepay liabilities. We have made structurally balanced budgets the norm. We have used one-time dollars prudently, for one-time uses only, and not to fund ongoing obligations. We have one of the strongest pensions in the nation. We have memorialized financial practice improvements in statute to help guide our state for the long-term after you and I are gone.

These practices are all paying dividends, and this past summer, we've received our final upgrade from Fitch ratings, earning South Dakota the top credit rating from all three major rating agencies.

All of these accomplishments are due to the conservative principles that we've upheld, together. As I close today, I'd like to take a moment to remember one person who deserves some of the credit for our strong financial position – our friend Dan Dryden.

As you know, we lost Dan in August, much too soon. I can't help but think of him as I give this speech – he was a longtime appropriator and a true numbers guy. I first came to know Dan during the 2011 Legislative Session, when the recession had left our state budget in structural

deficit. We had to make significant, unpopular cuts, and as an appropriator, Dan was right in the middle of that.

Dan had worked for years as the Rapid City school business manager, and he was up to the challenge. Like his fellow appropriators, and his fellow legislators, he faced those difficult choices with determination and courage.

In South Dakota, we can be very proud that our state is one of the most fiscally-sound in the nation. Dan Dryden deserves a lot of credit for that. He was a stalwart supporter of balanced budgets, conservative revenue estimates, and early debt repayment.

Dan shares that legacy with many other legislators, and with many governors, who have served our state throughout our history. This year, I look forward to working with all of you to continue this important work. Together, we are building an even stronger South Dakota.

Thank you all for being here today.