Comptroller of the Treasury

Quarterly Fiscal Affairs Report

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Section 3-7-103(d)(1), *Tennessee Code Annotated*, directs the Comptroller to make quarterly reports to the Fiscal Review Committee concerning the state's fiscal affairs. In this report, we provide a global look at the fiscal affairs, and in future reports, we plan to delve into topics of particular interest.

Comptroller's View of the State's Fiscal Affairs and Challenges Ahead ☆☆☆

Tennessee state government is in sound fiscal condition.

- ☆ Our current budget, adopted unanimously by our General Assembly, is balanced not only as required by Article II, Section 24 of our Constitution, but also on a recurring basis.
- ☆ For the first five months of the current budgetary year, general fund collections have exceeded our projections by approximately $188 million.
- ☆ Our current state debt is not excessive.
- ☆ We have budgeted on a recurring basis for payment of principal and interest on state-issued bonds.
- ☆ The state's retirement plan is sound.
- ☆ The post-employment benefit obligation for our retirees is manageable.
- ☆ Our unemployment trust fund is solvent.

This favorable financial outlook is in large part a result of the willingness of the General Assembly to enact budgets that have forgone, reduced or eliminated expenses and services as well as the ability of the administration to create efficiencies in operations.

This means, absent some catastrophic event, the state can for the foreseeable future, continue to operate and provide basic services to its citizens, but not necessarily at current levels.

Over the next few years, the cost of funding program increases already projected by current and prior administrations exceeds optimistic revenue projections. These projected increases do not include potential federal mandates, as of yet of uncertain scope, that may be required under President Obama's healthcare plan. It is doubtful that over the next few years, the state can, with current revenue levels, finance all the services currently provided. It certainly will not be able to make needed capital improvements and rebuild its reserves, unless the state continues to reduce expenses and to operate more efficiently.

If the General Assembly does not continue to reduce expenses and if the administration does not continue to increase the efficiency of operations, an optimistic scenario for the next few years would be a weak continuation of existing funding with inadequate reserves, as if the status quo were embraced as the priorities of the current administration and General Assembly. This is surely so if the General Assembly reverses the cuts it has already made and does not implement those projected. The priorities of the administration and the General Assembly would be determined by past, not current members. Tax reductions designed to spur our economy would become increasingly difficult or impossible to implement.

As we look toward the future, it is essential to plan for and stay cognizant of the challenges ahead.

Impact of Federal Cuts

Tennessee's budget is nearly $32 billion, of which $11 billion is attributable to state taxes, and approximately $13 billion is federal revenue. The remainder is represented by interdepartmental revenues, receipts from the state lottery, tuition and fees, etc. Recent activities in Washington indicate substantial uncertainty as to the level of federal funding the state may receive in the future. There could be a significant impact on the services the state is able to deliver.

The Governor's administration has produced a plan to demonstrate it can appropriately react to the discussed 15-30% reduction in funding from the federal government. While a reduction would certainly cause hardship, the state could continue to operate and provide services traditionally provided for citizens. Given the current status of the federal debate, where the cuts will be made and how services will be affected is yet to be known.

Our local governments continue to depend on state and federal governments to fund a large portion of their local budgets. As the federal funding decreases, local governments will be affected as well and should be planning for probable reduced funding scenarios.

Basic Education Program (BEP)

The BEP consumes about $3.8 billion, or 37% of the taxes in the general and education funds. The formula for determining BEP funding is complicated. It should nevertheless be transparent, verifiable, and understandable. Our reviews show the formula is none of these.

The BEP was conceived and the formula has, for the most part, been modified in an era without charter schools, virtual schools, Achievement School Districts, dual enrollment, dual credit, STEM academies, etc. As we continue to implement and evaluate the many education reform programs in the state, we should maintain our focus on the integrity of the funding process.

Tennessee Consolidated Retirement System (TCRS)

The Tennessee Consolidated Retirement System (TCRS) is a defined benefit pension plan covering four large groups of employees: state employees, higher education employees, K-12 teachers, and local government employees if the local government elects to participate in TCRS. The state is responsible for the pension liabilities associated with state employees and higher education employees.

The TCRS ended the 2011 fiscal year with net assets held in trust for pension benefits of $33.7 billion. The unfunded accrued liability at June 30, 2011, based on the actuarial value of assets totaled $1.6 billion for state and higher education employees. The actuarial value of asset methodology defers for these employees $1.0 billion of net market losses that will be recognized over the ensuing ten years. Using the market value of assets (no deferral of market losses) instead of the actuarial value of assets, the unfunded liability at June 30, 2011, totaled $2.5 billion for state and higher education employees.

In addition to investment return volatility and deferred investment losses, the TCRS faces issues related to improved longevity rates and increased pension liabilities. These may be offset in part by increasing the contribution that the state, as employer, makes. Since 1972, every General Assembly has appropriated the funds required to make the employer contributions to the system in the amount recommended by the system's actuary. It is essential that the TCRS and the General Assembly continuously review the plan to provide reasonable benefits while containing costs.

In comparison to the plans of other states, the TCRS is in very good position and if the General Assembly continues its practice of making the recommended employer contributions, the plan appears to be financially stable and the benefits appear secure.

Overall State Risk Assessment

It is important for the state to engage in an enterprise risk assessment. Currently, risk assessments are performed at the department level, but an examination of the state's risks, as a whole, is needed to ensure resources are allocated appropriately and the most significant risks that prevent the state from achieving its strategic objectives are mitigated. Other oversight functions should be strengthened as well, including oversight of contract monitoring and systems implementation activities.

In 2011, our Division of State Audit released the Review of Tennessee's Contract Monitoring and Management Systems. In that report, we recommended that the Department of Finance and Administration and the Chief Procurement Officer study the state's contract monitoring and management systems to identify specific actions to address central oversight issues and to report actions to be taken by October 1, 2012.

In an effort to improve processes and reduce costs, departments look for technology solutions to help them meet their unique needs. As with other states and private companies, Tennessee has had its share of information technology (IT) system development delays and failures. Most delays and failures can be attributed to scope creep and/or lack of adequate planning which leads to increased costs. These systems involve large sums of money. In 2010, after problems with initial Edison module implementations, the Division of State Audit recommended that a list of best practices and lessons learned be developed to assist the departments and agencies in identifying and mitigating risks with future systems development projects. Since that time, problems were identified with the systems development projects of the Department of Children's Services' TFACTS system, the Department of Revenue's TRUST system, and the Department of Human Services' VIP system. Based upon our experience over many years, until a formalized process is established which involves a central, and meaningful point of approval and on-going review of the acquisition and deployment of systems to provide independent accountability and transparency for these expensive and resource intensive projects, it is very likely delays in implementation, complete failures and ultimate abandonment of systems and wasted material expenditures of tax dollars that can be avoided will be repeated.

While the implementation of the Edison system has been completed and the system does seem to be functioning more appropriately, the state has still not fully utilized the functionality of the system.

Reserve Funds

For the year ended June 30, 2011, the reserve for revenue fluctuations (rainy day fund) had a balance of $283.6 million. The TennCare reserve fund had an unobligated balance of $234.7 million. The 2011 Appropriations Act sets the rainy day fund at $327.7 million and the TennCare reserve fund at $228.7 million at June 30, 2012. Combined, total reserves are projected to be $556.4 million at June 30, 2012.

The rainy day fund has not yet been adequately restored. Section 9-4-211, *Tennessee Code Annotated*, requires the governor to propose in his budget an amount at least equal to 10% of the estimated growth in state general fund tax revenues to be allocated annually to this reserve, until the reserve total reaches an amount that is equal to 5% of the estimated general fund revenue for that year.

The rating agencies have questioned the adequacy of the state's current reserves. This office believes the reserves should be increased. The increase will help the state withstand future unanticipated (or uncontrollable) events and help protect its citizens from loss of essential services during difficult years.

Financial Reporting

This year's *Comprehensive Annual Financial Report* (CAFR) was released December 29, 2011, allowing the state to meet the timeliness requirement for the Government Finance Officers Association's (GFOA) Certificate of Achievement for Excellence in Financial Reporting. The state is also currently on track to release the state's *Single Audit Report* by March 31, 2012, reporting on the state's compliance with federal requirements regarding disbursement of federal funds. Annual financial reports for Tennessee's 95 counties are ahead of schedule for release prior to March 31, 2012. Last year marked the first time in several years all Tennessee counties met this goal.

There has been a national discussion about the need for earlier government financial reporting. Currently, most state governments are able to release their CAFRs six months after the fiscal year end and release their *Single Audit Reports* nine months after the fiscal year end. The federal government is reexamining the 9-month *Single Audit Report* deadline and will likely shorten it. Much effort will be required at both state and county levels to meet any condensed time frames.

For decision-making purposes, the General Assembly often has to rely on unaudited interim financial statistics of questionable value provided by the departments. Such statistics may drive legislative decisions and, if incorrect, could result in incorrect decisions. We strongly recommend examining what can be done to gain more confidence in the interim figures, including interim reports, and we understand that the administration is addressing this issue.

The state does not currently have state-of-the-art project management and project accounting systems for capital projects. A system improvement would allow enhanced monitoring of capital projects and management of the capital outlay funding process. If the enhanced system allows access to all agencies involved in the capital outlay process, it would also provide much-needed transparency and accountability to support better timing of the state's debt issuances.

Civil Service

Although the Department of Human Resources has made significant changes in some areas to provide agencies more flexibility in hiring, the civil service system is still plagued with antiquated restrictions; subjective, complex, and time-consuming assessments for rankings; and other problematic issues, such as personal interviews not being conducted until after the registers are established, applicant's credentials not being verified until after the register is closed, and registers being saturated with large numbers of applicants who are not interested in the position. In fact, long-term employees must be on these registers to be eligible for promotions within their own department.

The dysfunction of the state's hiring process is driven home to officials seeking new staff who discover on the back-end of the process, after untold time and dollars have been spent, that the candidates lack the essential skills to perform the job.

Likewise, the procedures for termination of employees are antiquated and need substantial improvement, if not a complete overhaul, to allow state departments to manage their staffs more effectively and to allow state employees to better serve the people of Tennessee.

Changes in State Finance

The statute for management of state debt was written in the 1930s, and while it has been amended from time to time, should be reviewed in its entirety to reflect current conditions. For example, the revenues included in Section 9-9-106, *Tennessee Code Annotated*, include the gasoline tax and the special petroleum tax. This section of the code was last amended in 1973, when the state was issuing bonds to construct highways. The last bonds issued for highways were redeemed in 1988.

Other parts of the statute should be amended to conform to technical changes made at the federal level and to ensure compliance with the federal securities and tax regulations.

Changes in Local Finance

The Local Government Public Obligations Act of 1986 revised much, but not all, of the authority for local government debt, relocating those provisions in a single chapter. Anticipated centralization of the remaining debt authority did not occur and subsequent statutory authorizations have been codified elsewhere.

Investment Statutes

Likewise, the local government investment statutes must be reviewed. Given current market conditions, local governments are under pressure to maximize the return on idle cash while ensuring safety and liquidity. Short-term treasury bills provide no yield. Fewer banks are interested in purchasing certificates of deposit. However, the principles of safety and liquidity, not yield, should always be the foundation of investment policies. Investments should not be of a speculative nature. Due to current economic conditions and the need to maximize investment income, the statutes should be reviewed, simplified, and made both current and forward-looking.

State Procurement Office

Chapter 1098 of the Public Acts of 2010 set the course toward procurement reform through restructuring the procurement organization and creating an appointed leadership position to steer the state toward the creation of efficient and effective processes; more transparency, accountability, and competition; and making it easier for vendors to do business with our state. The state saw the appointment of the first Chief Procurement Officer in July 2011. The Advisory Council on State Procurement, which consists of representatives from the executive and legislative branch, vendor community and government procurement profession, met for the first time in November 2011. To date, all indications are that steps have been and continue to be taken toward properly implementing the procurement organization that will recommend changes to the process that could bring substantial improvements and cost savings to the state. If improperly implemented, the risk of waste and abuse increases, which would threaten the integrity of the process and increase litigation costs. The fiscal review committee should continue to closely monitor the progress of this restructure and changes in processes.

Status of County Governments

Compared with county governments elsewhere in the country, the financial condition of Tennessee counties is generally good. Of course, all counties have been affected by poor economic and market conditions.

Managing debt service obligations in the face of decreasing revenues is a serious challenge. Some counties have a high long-term debt per capita ratio. There are also debt management issues regarding the amount of variable rate debt being held by county governments and the structuring of the debt that results in excessively high payments in later years.

In many counties, the same findings are repeated year after year without any effort being made to correct them.

Observations about Local Governments

The State Funding Board established a requirement that all governmental entities incurring debt have a written debt management policy in place by December 31, 2011. Many governments met the deadline and voluntarily submitted copies to the Office of State and Local Finance. During the last fiscal year, that Office approved 329 short-term debt issues (in an approximate amount of $608 million) for local governments and reported on 70 plans for refunding debt (for a total of $1.316 billion) submitted by local governments.

In addition to work done by other investigative entities, the Office of the Comptroller of the Treasury issued investigative reports on 26 local government entities monitored by the Division of Municipal Audit during the year ended December 31, 2011. Frauds totaling $645,000 were discovered in 13, or one half, of the investigations, while $2,805,000 was related to waste and abusive use of public funds. Twenty (20) cash shortages resulting from fraud, mismanagement, or accounting errors totaling $689,284 were identified in county entities for the calendar year. County government internal controls help to expose the misuse or improper accounting of public funds. For local governments, the economy could be a factor affecting the number of cash shortages. As local government budgets are squeezed by the economy, shortcuts are found and, in those cases, internal control is sometimes compromised.

At the time of this report, 94 of the 95 counties have successfully completed redistricting at the county level.

In upcoming quarterly reports, we plan to examine in detail some of the topics mentioned above, or any other pressing issue.

Justin P. Wilson

Comptroller of the Treasury

State of Tennessee Indebtedness and Other Significant Obligations

as of December 31, 2011

	Moody's/S&P/Fitch Credit Ratings	Debt Outstanding	
General Obligation Debt			
Long-term General Obligation Bonds	Aaa/AA+/AAA	$	2,072,230,000
General Obligation Commercial Paper	P-1/A-1+/na	$	123,550,000
		$	2,195,780,000
Tennessee Local Development Authority			
Bonds issued and outstanding	Aa3/AAA/AA	$	8,845,000
Tennessee State School Bond Authority			
Higher Education Facilities Program			
Long-term Bonds	Aa2/AA/AA+	$	1,018,980,000
Commercial Paper	P-1/A-1+/na	$	195,480,000
		$	1,214,460,000
Qualified Zone Academy Bond Program			
Long-term Bonds	n/a	$	43,920,000
Qualified School Construction Bonds			
Series 2009	Aa1/AA/na	$	177,000,000
Series 2010	Aa2/AA/AA	$	212,440,000
Tennessee Housing Development Agency (THDA)			
Long-term Bonds	Aa2/AA/na	$	2,266,455,000
Total State Indebtedness		**$**	**6,118,900,000**
Capital Leases		$	15,503,000
Pension Plan - Unfunded Actuarial Accrued Liability		$	1,554,631,358
Other Post-employment Benefits			
State		$	1,561,548,000
Component Units		$	518,083,000
		$	2,079,631,000
Additional Obligations		**$**	**3,649,765,358**
Total State Indebtedness and Significant Obligations		**$**	**9,768,665,358**

The total amount of obligations listed above represents approximately 90% of the annual state tax collections and does not include approximately $1 billion of unrecognized losses in TCRS.

Revenue Projections

Based on economists' predictions that the economy is rebounding, but slowly, general fund revenue growth projections range from 4.20% to 4.58% for the year ended June 30, 2012, and from 3.75% to 4.03% for the year ended June 30, 2013. Total tax revenue growth projections range from 3.90% to 4.21% for the year ended June 30, 2012, and from 3.40% to 3.65% for the year ended June 30, 2013. To view the State Funding Board lettter, go to the Comptroller website Investor Update for December 22, 2011. www.tn.gov/comptroller

General Obligations of the State of Tennessee

As of December 31, 2011, the state has $2,072,230,000 in long term general obligation debt outstanding and $123,550,000 in short term general obligation debt structured as commercial paper. The state also has authorized, but unissued, debt of $1,618,386,223. Of that amount $953,700,000 is allocated to fund highway improvements and bridge improvements. The remaining $664,686,223 is allocated for general state and economic development projects previously approved by the General Assembly.

Post-employment Benefits

The unfunded actuarial liability related to post-employment health benefits exceeds $1.5 billion. These benefits are currently funded on a pay-as-you-go basis through the state's employee health plan. The additional unfunded actuarial liability related to component units exceeds $500 million.

Unemployment Trust Fund

As of December 30, 2011, the state unemployment trust fund had a balance of $308,937,445. The administration does not anticipate having to borrow funds from the federal government in the near future.

Tennessee Comptroller of the Treasury

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