Comptroller of the Treasury

Quarterly Fiscal Affairs Report

Volume 2, Number 1
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State law 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 state fiscal affairs.

Comptroller's View of State's Fiscal Affairs

The fiscal health of Tennessee state government is sound.

- The current state budget, enacted by the General Assembly, is balanced not only as required by Article II, Section 24 of the state Constitution, but also on a recurring basis.
- In the first five months of the current fiscal year, general fund collections increased 3.63% over collections from the same period during the previous year.
- 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.
- The state's unemployment trust fund is solvent.

In contrast with many other state governments, Tennessee is financially healthy. 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, as well as the ability of the administration to create efficient operations.

Absent some catastrophic event, the state can for the foreseeable future continue to provide basic services to citizens, but not necessarily at current levels.

Recent Accomplishments

- ***Passed a balanced budget***
- ***Cut taxes on citizens***
- ***Reduced the size of government***
- ***Saved $60 million by refunding debt***
- ***Improved timeliness of financial reporting***

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.

Challenges Ahead

Tennessee has experienced significant revenue growth over the past couple of years. Even so, the cost of program increases projected by the administration exceeds optimistic revenue projections. Additionally, these projections do not include the costs, yet unknown, that will be incurred by President Obama's healthcare act and other potential federal mandates. At current revenue levels, over the next several years it is doubtful the state can continue to finance all the services currently provided. Much-needed capital improvements and reserve fund replenishment will not be possible unless the administration and the General Assembly continue to reduce expenses and to operate more efficiently.

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

Tax Cuts

In 2012 the General Assembly passed legislation to eliminate the tax on gifts. The General Assembly began phasing out the state inheritance tax, better known as the "death tax," over three years, completely eliminating it by January 1, 2016. Another reduction lowered the sales tax on food from 5.50% to 5.25%. Additionally, the General Assembly extended property tax relief to surviving spouses of soldiers whose deaths resulted from deployment.

> ***In 2012, the General Assembly enacted three tax cuts aimed to assist the citizens of Tennessee.***

Revenue Projections

Based on economists' predictions that the economy is continuing to rebound, albeit gradually, the State Funding Board projected general fund revenue growth projections ranging from 1.98% to 2.85% for the year ending June 30, 2013, and from 2.74% to 3.89% for the year ending June 30, 2014. Total tax revenue growth projections range from 1.91% to 2.65% for the year ending June 30, 2013, and from 2.55% to 3.49% for the year ending June 30, 2014. The Governor chose to use a general fund growth rate of 3.89% for his budget.

Reserve Funds

For the year ended June 30, 2012, the reserve for revenue fluctuations (rainy day fund) had a balance of $306 million. The TennCare reserve fund had an unobligated balance of $176 million. The 2012 Appropriations Act sets the rainy day fund at $356 million and the TennCare reserve fund at $111 million at June 30, 2013.

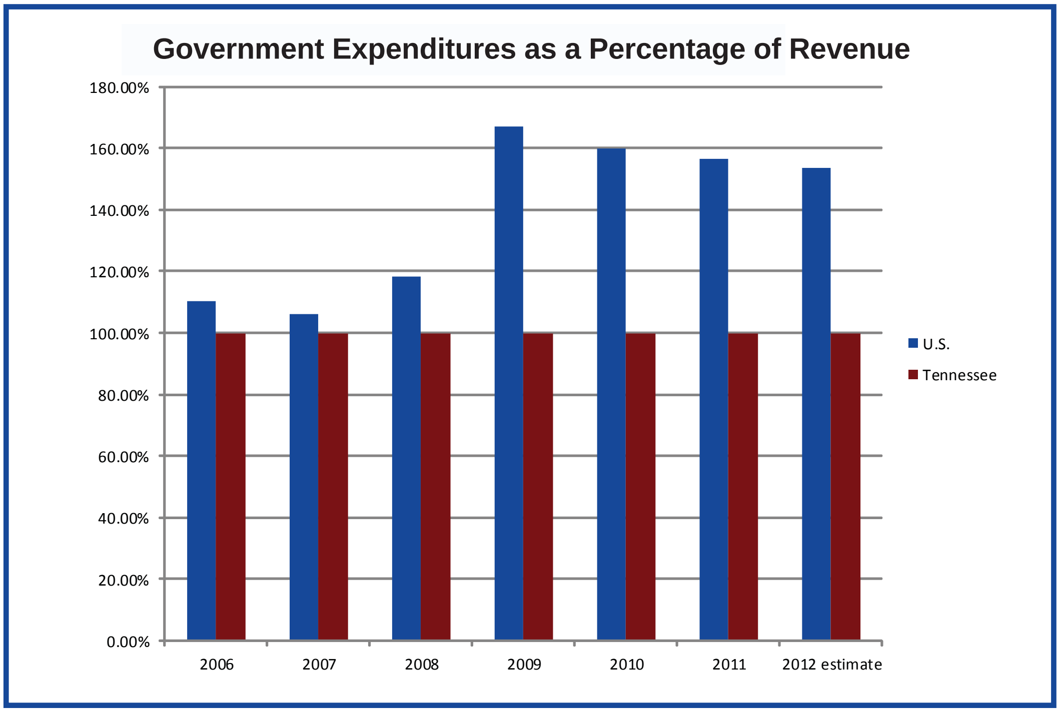
Following depletion during the economic downturn, the rainy day fund has not been adequately restored. Increasing the rainy day fund and setting a formal policy concerning its use are marks of financial responsibility that will be noted by the agencies that rate the state's credit. For example, in developing credit ratings each rating agency considers the state's reserve fund along with several other factors. To achieve the top score of "1" under this category for one rating agency, Standard & Poor's, the state must demonstrate a formal budget-based reserve relative to revenue or spending that is above 8% and a formal process or track record of restoring following depletion.

> ***The rainy day fund has not been adequately restored. This office believes the reserve amount should be increased.***

Impact of Federal Cuts

Tennessee's budget is approximately $32.6 billion, of which slightly more than $12 billion is attributable to state taxes, and about $12.3 billion is from federal funds. The remainder represents interdepartmental revenues, receipts from the state lottery, and tuition and fees. Recent activities in Washington indicated substantial uncertainty as to the level of federal funding the state may receive in the future. If federal funds were to be reduced, services the state is able to deliver could be significantly impacted.

The Governor's staff has produced a plan to demonstrate it can appropriately react to a significant reduction in federal government funding. While a reduction would certainly cause hardship, the state could continue to operate and provide essential services to 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 determined.



The Affordable Health Care Act, commonly known as Obamacare

Obamacare implements significant changes to the administration of health care nationwide. Many of these changes will be made by January 1, 2014. Because many important details have yet to be unveiled, it is difficult to know the full impact this program will have on Tennessee. The administration estimates net cost of this health reform to the state could total as much as **$1.4 billion** over the first five and a half years of implementation.

State Health Insurance Costs

During the economic downturn, the state sought significant cost savings from the state's contribution for health benefits. For plan year 2011, the Insurance Committee voted to restructure the State Employee Health Plan to accomplish the following goals:

- Give beneficiaries greater financial stake in their health and health care purchasing decisions;
- Leverage the state's purchasing power and vendor core competencies to drive costs down;
- Build data-driven cost containment and health management practices into the plan design;
- Increase the accountability of contractors, providers and members

Though state costs decreased during the restructuring, the costs for the state's health benefits continue to increase at rates that exceed revenue growth. Total premium amounts grew by 2.52% in calendar year 2011 and by 4.12% in calendar year 2012. With unknown changes due to Obamacare on the horizon, monitoring the cost of health benefits will be very important in the future.

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 2012 fiscal year with net assets held in trust for pension benefits of $34.9 billion. The unfunded accrued liability at July 1, 2011, the date of the last actuarial valuation, based on the actuarial value of assets totaled $1.5 billion for state and higher education employees. The actuarial value 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 or market losses) instead of the actuarial value of assets, the unfunded liability at July 1, 2011, totaled $2.5 billion for state and higher education employees. The next actuarial valuation will occur on July 1, 2013. The TCRS investment return for fiscal year 2012 was 5.6%.

Superb management has put the TCRS in a very good position in comparison to the plans of other states.

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, provides. Since 1972, every General Assembly has appropriated the funds required to make 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.

State Employment Policy Update

The Tennessee Excellence, Accountability, and Management (T.E.A.M.) Act of 2012 reformed the state's employment practices from the former civil service provisions to a system of personnel administration aimed at giving agencies a greater level of flexibility in personnel employment and management to increase the overall productivity and success of state government. The purpose of the Act was to reform the civil service system which has long been plagued with antiquated, complex and time-consuming restrictions that hinder state departments from managing their staffs efficiently and effectively.

The T.E.A.M. Act creates a new hiring system that requires agencies to define minimum qualifications and specifically identify the knowledge, skills, abilities and competencies required for each position. The commissioner refers a list of eligible individuals who meet the minimum qualifications for the position. The agency must interview at least three candidates from the referred list, and one of the people interviewed must be hired within 30 days. The Act requires a minimum probationary period of one year and provides that employee evaluations of state service employees are not public records. The T.E.A.M. Act requires that employee performance standards and expected outcomes be specific, measurable, achievable, relevant to the strategic objective of the employee's state agency or division, and time sensitive.

The goal of the T.E.A.M. Act is to allow state departments to attract, select, retain and promote the best employees based on merit.

Although too early to evaluate the effectiveness of the new employment practices, this office is monitoring these changes.

Financial Reporting

The Comprehensive Annual Financial Report (CAFR) was released on December 21, 2012, marking the second consecutive year the state has met the timeliness requirement for the Government Finance Officers Association's (GFOA) Certificate of Achievement for Excellence in Financial Reporting. This office is currently on track to release the state's Single Audit Report, reporting on the state's compliance with federal requirements regarding disbursement of federal funds, by March 31, 2013.

For the second consecutive year the Comprehensive Annual Financial Report was released in a timely manner.

The year 2011 marked the first time in memory, certainly in the 21st Century, that the financial statements of all of Tennessee's 95 counties were timely filed to meet federal deadlines. We are pleased to report that again, in 2012, all 95 were completed on a timely basis.

The administration recently began placing more emphasis on frequent review of expenditures. At the end of each month, agency leaders are actively reviewing actual revenues and expenditures and comparing them to agency budgets.

County Government Finances

While Tennessee's counties avoided the bankruptcy crisis seen in other parts of the nation, several concerns regarding county finances remain. For the fiscal year ended June 30, 2011, Tennessee county governments spent approximately $500 million more than they received in general and operating revenues. Additionally, total county-related debt increased by more than $1.4 billion from 2007 to 2011. Many counties are deferring principal payment and other obligations to future years. With rising demands for services and sluggish revenue growth, county governments are left considering difficult proposals to cut expenditures or implement unpopular property or sales tax increases.

The vast majority of findings and adverse opinions are reported in counties that do not have a centralized system of accounting, budgeting, and purchasing.

County governments in Tennessee operate accounting, budgeting, and purchasing activities under the provision of general statute, private act, or two financial management acts, the most recent of which was enacted in 1981. Now, 32 years after the most recent focus on the importance of centralized accounting, budgeting, and purchasing, many county governments still are not centralized and do not have a financial management staff equipped to handle the complicated financial issues facing county governments.

Oversight of Education Funding

The Basic Education Program (BEP) is the state's funding formula for K-12 education. The BEP consumes $4 billion, or 40% of the taxes in the general and education funds. The formula for determining BEP funding should be transparent, verifiable, and understandable. Our reviews show this complicated formula is none of these.

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The Complete College Act of 2010 (CCTA) was passed in a January 2010 special session. The legislation set the tone for a comprehensive reform agenda to transform public higher education. The CCTA includes key changes to Tennessee's higher education structure that aim to enhance collaboration between the Tennessee Board of Regents and the University of Tennessee systems. Changes to the higher education funding formula were also incorporated in the CCTA. Funding is now based on student outcomes rather than enrollment. While the new formula may be appropriate, no agency outside of the higher education community evaluates compliance or quality control. Independent oversight should be developed to ensure high academic standards and monitor graduation rate reporting to ensure the integrity of the new funding formula.

K-12 Challenges and Opportunities

Several K-12 education reforms have been implemented over the past few years, but evidence suggests more reform efforts are needed. While state test scores have recently increased across all areas, with particularly high increases in math and science, nearly half of Tennessee's students still fail to score at grade level in reading and math, demonstrating that significant work remains.

> ***While state test scores have increased recently, nearly half of Tennessee's students still fail to score at grade level in reading and math.***

The state's teacher evaluation system showed that most teachers are performing at a high level, exceeding expectations on both quantitative and qualitative ratings. One in six teachers (16.5%), however, scored the lowest possible score of 1 on that portion of their evaluation based on three-year individual average value-added scores (TVAAS). Most of these teachers continue to teach students with no real consequences. Complicating the problem, almost all school districts in Tennessee pay teachers strictly on the basis of years of experience and degrees earned despite statistical evidence demonstrating that these factors have limited correlation to student learning. This represents close to $1 billion of state money per year.

The Tennessee Higher Education Commission publishes a report card each year rating the state's teacher preparation programs based on the outcomes of their graduates. A number of universities have received consistently low ratings, yet they continue to produce hundreds of new teachers each year.

As the need for serious education reform efforts continues, the General Assembly will be faced with more difficult decisions in the future.

Information Systems Problems

The Business Solutions Delivery (BSD) Division within Finance & Administration was created to provide resources, methodologies and best practices to agencies in support of large, complex information technology (IT) implementations. The division has built a team of project directors, project managers and business analysts experienced in the practices and disciplines of implementing large scale IT solutions. Additionally, the team has hired three distinct specialists to help address key risks in IT projects: organizational change management, testing & quality assurance and project cost management.

> ***The cost of several failed Information Technology projects led to the creation of the Business Solutions Delivery Division in late 2011.***

BSD has created a standard IT project management methodology and supporting templates to help drive standardization and discipline across all agency projects. An introductory web-based training course has been developed, as well as classroom courses for project managers and business analysts regarding the methodology. Additional templates and methodologies are being developed to support organizational change management and testing & quality assurance. A Project Budget to Actual Tracking Model has been created to improve project tracking and management of costs. BSD resources are partnering with several agencies embarking upon the planning, procurement and implementation by providing project leadership and support while promoting best practices and discipline. These collective approaches are expected to improve the outcomes for the large IT initiatives in which BSD is involved.

The administration believes these changes will address serious difficulties the state has experienced with major information systems. This office is monitoring their progress.

State of TN Indebtedness and Other Significant Obligations

As of December 31, 2012		
	Moody's/S&P/Fitch Credit Ratings	Debt Outstanding
General Obligation Debt		
Long-term General Obligation Bonds	Aaa/AA+/AAA	$ 2,041,930,000
General Obligation Commercial Paper		$ 174,799,000
		2,216,729,000
Tennessee Local Development Authority		
Bonds issued and outstanding	Aa3/AA+/AA	$ 7,620,000
Tennessee State School Bond Authority		
Higher Education Facilities Program		
Long-term Bonds	Aa1/AA/AA+	$ 1,221,990,000
Commercial Paper		$ 121,143,173
		$ 1,343,133,173
Qualified Zone Academy Bond Program		
Series 2009	Aa1/AA/n/a	$ 177,000,000
Series 2010	Aa1/AA/AA	$ 212,440,000
Tennessee Housing Development Agency		
Long-term Bonds 1974 1985 2009	Aa2/AA/n/a Aa1/AA+/n/a Aa2/n/a/n/a	$ 2,049,295,000
Total State Indebtedness:		**$6,050,137,173**
Capital Leases		$ 14,142,000
Pension Plan - Unfunded Actuarial Accrued Liability		$ 1,554,631,358
Other Post-employment Benefits		
State		$ 1,623,943,000
Component Units		$ 452,669,000
		$ 2,076,612,000
Additional Obligations		**$ 3,645,385,358.00**
Total State Indebtedness and Significant Obligations		**$ 9,695,522,531.00**

General Financial Information ☆☆☆

General Obligations of the State of Tennessee

As of December 31, 2012, the state has $2,041,930,000 in long-term general obligation debt outstanding and $174,799,000 in short-term general obligation debt structured as commercial paper. The state also has authorized, but unissued, debt of $1,747,306,223. Of that amount $932,100,000 is allocated to fund highway and bridge improvements. The remaining $815,206,223 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 $1.6 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 31, 2012, the state unemployment trust fund had a balance of $547,167,412. Tennessee, along with 30 other states, does not have an outstanding loan balance with the federal government for its unemployment insurance trust fund. The administration does not anticipate having to borrow funds from the federal government to maintain solvency of the unemployment trust fund in the near future.

Comptroller of the Treasury

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