Comptroller of the Treasury

Quarterly Fiscal Affairs Report

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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 Tennessee's fiscal affairs.

Comptroller's View of State's Fiscal Affairs ☆☆☆

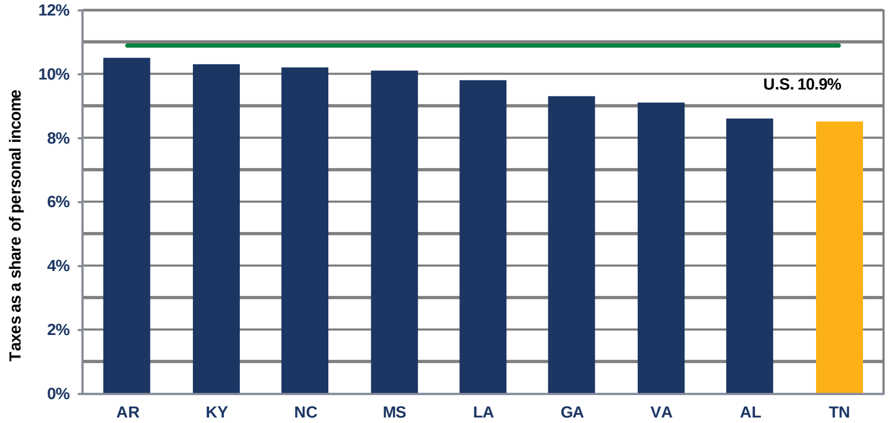
The fiscal health of Tennessee state government is sound.

- 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.
- Our current state debt is not excessive. The state's general obligation debt has decreased in the last year.
- 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 appropriately funded.

In contrast with many other state governments, Tennessee is financially healthy. This favorable financial position 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 truly catastrophic event, the state can, for the foreseeable future, continue to provide basic services to citizens, though not necessarily at current levels.

While Tennessee has experienced significant revenue growth over the past couple of years, collections are less than anticipated for the current fiscal year. The Funding Board projects modest growth for the remainder of this fiscal year and next. In fact, most if not all of the growth in the coming fiscal year is expected to be absorbed by cost increases in TennCare and funding the growth in the BEP, the state's funding formula for K-12 education. This means that the state must reduce or eliminate existing programs or expenses in the coming year approximately equal to the cost of any new or expanded program or tax cut.

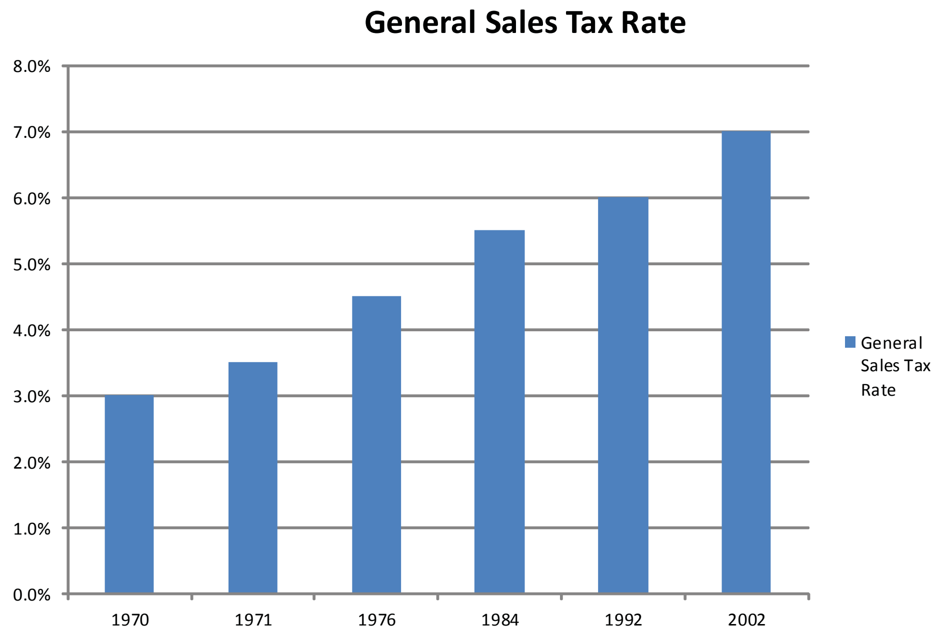
State Taxes



Tennessee is a very low-tax state.

In 2013, the General Assembly reduced the state sales tax on groceries from 5.25% to 5.00% to save taxpayers approximately $25 million statewide. Tennessee has now implemented the second phase of the elimination of the death tax. When the tax is fully repealed in 2016, it will represent a $94.6 million tax cut. The Hall tax—an income tax on individuals and entities receiving interest from bonds and notes and dividends from stocks— was cut for seniors 65 and older by raising the income exemption level from $26,200 to $33,000 for single filers and from $37,000 to $59,000 for joint filers.

The state has not always reduced taxes. According to the Tennessee Department of Revenue, Tennessee has implemented five major tax increases since 1970 with an average increase of 18.64%.

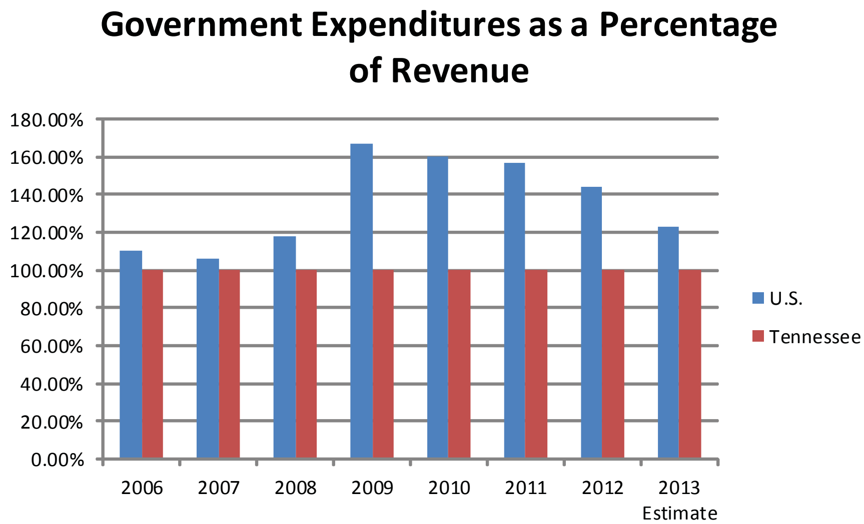


Over 58% of the state's general fund tax dollars come from the sales tax. This is primarily a tax on the sale of tangible goods. An additional 16% comes from our franchise and excise taxes on business. There is growing anecdotal evidence that businesses are becoming increasingly engaged in developing strategies to manage this tax liability. Thus, over the next few years, the state has a major challenge in keeping Tennessee a very low-tax state. To do this, the General Assembly will be forced to make difficult decisions about services and programs for our citizens.

Impact of Federal Programs

Tennessee's 2013-2014 budget document presents a total state budget of approximately $32.7 billion. The proposed budget would be funded by approximately $15 billion in state appropriations, approximately $12.9 billion in federal funds and about $4.8 billion from other revenue sources.

Programs substantially funded by federal funds include Food Stamps, Temporary Assistance to Needy Families, Unemployment Insurance, Title I Education, and several environmental programs. Some of these programs, such as SNAP (food stamps), are funded almost entirely with federal funds; others such as TennCare, our Medicaid program, require a state match. Some require a "maintenance of effort" test, meaning that the state must maintain a certain level of funding under rules the federal government sets forth. Almost all have federal requirements attached.



Note: Total Tennessee state government expenditures as a percentage of revenue includes spending and deposits to reserve funds.

As we recently saw in the Build America Bond program, federal assurances of continuing promised funding do not always materialize, although the local government obligations, which rely on the federal assurances, continue. As federal spending is far outpacing federal revenues, federal funding of state-administered programs is at substantial risk of cuts or even elimination. The consequences of such cuts are as yet unknown.

The Governor's staff has produced a plan for appropriate state action in the event of a significant reduction in federal government funding. This plan was partially implemented during the development of the 2013-2014 enacted budget. The administration reduced the federal revenue estimate by $71.8 million.

There is no question that reductions in federal funding will cause substantial hardship. But the state must be extremely cautious before it uses state general funds to supplant any reduced federal funding. The cost of food stamps alone would exceed $40 million a week.

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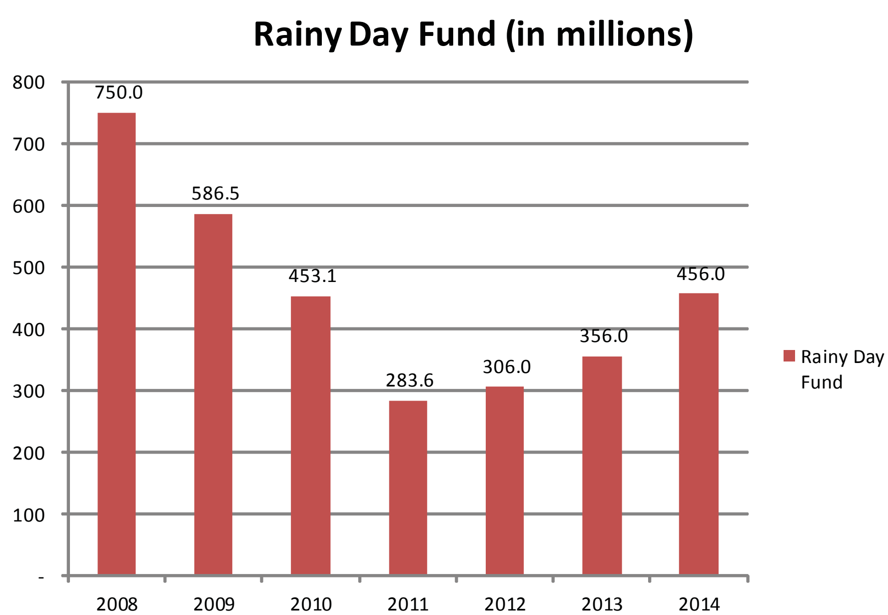
Reserve Funds

For the year ended June 30, 2013, the reserve for revenue fluctuations (Rainy Day Fund) had a balance of approximately $350 million and the TennCare reserve had an unobligated balance of approximately $300 million. The 2013 Appropriations Act added $100 million to the Rainy Day Fund.

Although the $100 million addition is a meaningful step in the right direction, the Rainy Day Fund has not been adequately restored following the Great Recession of 2008. Increasing the Rainy Day Fund and setting a formal policy concerning its use are marks of financial responsibility that will be considered by the agencies that rate the state's credit. In 2013, the General Assembly set as a goal increasing the Rainy Day Fund until it reached 8% of state tax revenues to the general and education funds. Currently the Rainy Day Fund is equal to 3.8% of general and education fund state tax revenue.



Education

Approximately one-third of the states have reduced funding for K-12 education. Fortunately, Tennessee is not among that group, though our expenditures for K-12 education are less than the national average. According to *Education Week*, in 2011, Tennessee's per-pupil expenditures averaged $9,230, making it among the lowest funded states in the nation.

The Basic Education Program (BEP) is the state's funding formula for K-12 education. The BEP accounts for $4 billion, or 40% of the general and education funds. The BEP formula used to determine the distribution of this significant amount of money should be transparent, verifiable, and understandable. Our reviews show this complicated formula is none of these.

In the last few years, Tennessee has undertaken an array of K-12 education reforms, including enhanced student expectations in the form of revised academic standards and assessments, and changes to teacher evaluation and pay. Tennessee received positive news on the 2013 National Assessment of Educational Progress (NAEP) results, with statistically significant gains on all four NAEP tests, which may suggest that the reforms are moving the state in the right direction. Tennessee was one of only three states/jurisdictions that scored higher in 2013 than in 2011 in both reading and math for the grades tested. Although Tennessee's NAEP scores remain below the national average, its gains on NAEP are significant.

In January 2010, Tennessee passed the Complete College Tennessee Act (CCTA), a comprehensive reform agenda that seeks to transform public higher education through changes in academic, fiscal, and administrative policies at the state and institutional level. At the center of these reforms is the need for more Tennesseans to be better educated and trained, while also acknowledging the state's diminished fiscal capacity to support higher education.

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In pursuit of this aim, the Haslam administration has set the goal of increasing the percentage of Tennesseans with a postsecondary credential from 32% to 55% by 2025, called the "Drive to 55" initiative. Progress to date includes:

- Launch of Western Governor's University (WGU) Tennessee, an online, competency-based university aimed at the 940,000 adult Tennesseans that have some college credit but didn't graduate with an associate's or four-year degree.
- Appropriation of $16.5 million in the 2013-14 budget for equipment and technology related to workforce development programs at Tennessee colleges of applied technology and community colleges.
- Creation of new endowment of $47 million using operational reserve funds from the Tennessee Student Assistance Corporation to provide nearly $2 million annually to support "last dollar" scholarship programs, such as tnAchieves. These scholarships fill the gaps between students' financial aid and the costs of college, including books, supplies, and room and board.
- Development of the SAILS (Seamless Alignment and Integrated Learning Support) program, to give high school students extra support in math during their senior year to avoid remediation when they enter college.
- Adoption of a "reverse transfer" program, which, beginning next year, will allow Tennessee community college students who transfer to any of the state's four-year colleges (including some private institutions) without attaining a credential to receive an associate's degree while in pursuit of a bachelor's degree.

Tennessee Consolidated Retirement System (TCRS)

The Tennessee Consolidated Retirement System (TCRS) is a non-contributory 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. School districts are responsible for pension liabilities associated with teachers. Each of the nearly 500 local governments participating in TCRS is responsible for the pension liabilities associated with their employees. While separate accounting and actuarial records are maintained for each group, assets for each group are commingled for investment purposes.

For state employees and higher education employees, the TCRS ended the 2013 fiscal year with net assets of approximately $11.5 billion held in trust for pension benefits. The unfunded accrued liability on July 1, 2013, the date of the last actuarial valuation, based on the actuarial value of assets, totaled $1.36 billion. The TCRS investment return for fiscal year 2013 was 9.92%. The annualized return was 11.56% for the last three years and 5.33% for the last five years. In addition to investment return volatility and deferred investment losses, the TCRS faces issues related to the fact that retirees are living longer.

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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 this practice continue. Largely because of this, the TCRS is in sound financial condition compared to other states' systems.

Effective July 1, 2014, all newly hired state and higher education employees will be enrolled in a hybrid pension plan that is a combination of a defined benefit plan and a defined contribution plan. The total maximum employer cost for the hybrid plan will be 9% of salary. Automatic adjustments will take place to maintain the 9% level. Moreover, there will be automatic controls to keep the unfunded liabilities to no more than 12.5% of the state's outstanding bond indebtedness. While the cost controls and the unfunded liability controls apply only to the hybrid plan and do not apply to the legacy plan, these controls will over the years substantially reduce the state's risk exposure. The General Assembly's action in creating the hybrid plan is a significant step in assuring the long-term financial health of the state.

Infrastructure of Tennessee

Tennessee is one of five states with no transportation debt. This enables the Tennessee Department of Transportation (TDOT) to put more of its $1.8 billion budget into projects instead of debt service. Although maintaining a debt-free transportation system is a significant accomplishment, we should acknowledge that there is also an $8.5 billion backlog of projects. These are projects that have had dollars expended in some form. TDOT has begun expedited project delivery in which project budgets have been cut in exchange for immediate funding.

According to the 2013 Report Card for America's Infrastructure by the American Society of Civil Engineers, 1,195 of the 19,985 bridges in Tennessee (6.0%) are considered structurally deficient and 2,669 (13.4%) are considered functionally obsolete.

TDOT's revenue from the gasoline tax of 21.4 cents per gallon has been declining due in part to automobiles operating more efficiently. The tax is based on number of gallons sold without considering the price per gallon. This causes the revenue from the gasoline tax to be inelastic and the General Assembly must decide if time and technology have bypassed the formula used.

State Health Insurance Costs

State employees can participate in a state sponsored health insurance plan. The state pays up to 80% of the cost of the plan for full-time state employees. From 2011 through 2015, the cumulative additional estimated cost to the state insurance plan due to the Affordable Care Act, commonly called Obamacare, is approximately $57 million. Of that amount, approximately 55% is associated with the provision that extends adult child coverage to age 26. The next largest expense, approximately 27%, is the transitional reinsurance fee to partially offset the risk of high-cost individuals once health insurance exchanges become available.

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Tennessee's Buildings

The average age of our state government buildings is 35 years and the amount of deferred maintenance suggests the state has adopted a "run-to-fail" approach to maintenance. Run-to-fail simply means that the organization will expect failures and will maintain sufficient spare parts and staff to keep the downtime below organizational requirements. This is usually the fallback position for organizations that have manpower shortages and/or budget issues. This method of asset management prevents staff from being proactive and forces them to be reactive "firefighters." The current administration is aggressively addressing this issue and proposes to change radically the way it manages state real estate. While the administration is experiencing a number of issues in implementing these changes, the initial results appear promising.

Information Technology (IT) Systems

Substantial costs are associated with ineffective IT system implementation projects, not only in dollars wasted, but also in terms of negative impact on the people the state is serving. Failing to take appropriate action to establish accountability and transparency in systems acquisitions will result in continued excessive costs and inefficiencies.

Examples of information systems that have encountered significant issues during development and/or implementation include the Department of Intellectual and Developmental Disabilities' Community Service Tracking System, the Department of Children's Services' Tennessee Family and Child Tracking System (TFACTS), the Multi-Agency Regulatory Systems (MARS), the Department of Safety's Driver License Information System, the Department of Health's Vital Records Information System, the Department of Revenue's Title and Registration Users System (TRUST), and the Department of Human Services' Vision Integration Platform (VIP), and FOCUS system.

The Governor's Customer Focused Government Committee's systems work group recommended a centralized Business Solutions Delivery team to lead large and high-risk agency systems implementations. This centralized oversight would provide accountability, control the acquisition and implementation of major systems based on best practices, and leverage lessons learned from previous successes and failures.

It is imperative that the state develop a formalized process that involves a central, knowledgeable, and meaningful point of approval and transparent, ongoing review of the acquisition and deployment of systems. Until such action is taken, we are likely to repeat our past mistakes, resulting in delays in implementation, failures, and ultimate abandonment of systems involving significant taxpayer dollars.

The administration is addressing these most challenging issues. Limited, anecdotal information concerning the Business Solutions Delivery team and related efforts is positive.

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Cost of Methamphetamine Production

The illicit production of methamphetamine is a serious public health and safety issue; it also creates considerable fiscal problems, not only for the state but particularly for local communities.

Methamphetamine is a highly addictive drug that can be easily produced by individuals with certain over-the-counter cold and allergy medications and everyday household products and chemicals. The dangers and associated costs of methamphetamine go beyond the effects on the health and productivity of the drug abuser. The explosiveness and toxicity of the labs and dumpsites of waste materials pose significant dangers and costs to families of those making methamphetamine, the community, law enforcement personnel, and workers who clean up the contaminated properties.

The cost of treatment for badly burned meth victims can exceed $1 million.

Dealing with the public health and safety consequences of methamphetamine labs requires significant federal, state, and local funding and resources. Medical costs for burns suffered in explosions are significant and seldom covered by patients or insurance. Health consequences for persons exposed to the toxic chemicals used and emitted in the production process, especially children, are severe. Child protective and foster care costs for children found at methamphetamine lab sites are significant. Law enforcement agencies, supported with federal and state funding as available, are financially responsible for the cleanup of the toxic labs' waste. In addition, property owners are responsible for paying to remediate property contaminated by the residual toxic waste.

Sufficient information is not available to develop an overall cost estimate of the impact of methamphetamine production in Tennessee, but here are some specific costs:

- Between January 2010 and September 30, 2013, 1,305 children were placed in Department of Children's Services' custody due to exposure to methamphetamine production and/or use, at a total estimated cost of $30 million.
- According to the Tennessee Methamphetamine and Pharmaceutical Task Force, in addition to at least $1,000 for initial toxicity testing, remediation cost of a single home can range from $5,000 to $25,000.
- The cost of treatment for badly burned meth victims can exceed $1 million.

Status of Local Governments

While the financial condition of Tennessee counties remains good, all counties continue to be affected by sluggish revenue growth and an increasing demand for services. County governments are left to consider difficult proposals about whether to cut expenditures or implement tax increases. Additionally, total county-related debt increased by more than $1.1 billion from 2009 to 2012. This figure does not include other long-term obligations such as compensated absences, other post-employment benefits, and pensions. Many counties are deferring principal payment and other obligations to future years.

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There are also issues that hamper effective financial management at the county level. A lack of expertise among county employees charged with accounting, budgeting, and purchasing leads to repeated audit findings. Furthermore, there are no minimum qualifications or continuing education requirements for individuals elected to public office or put in charge of a county's multimillion dollar budget. Counties are not required to establish long-range plans regarding capital assets, cash management, and investments. In many counties, there is a duplication of accounting services among the general government, highway department, and school department.

A number of counties have established audit committees which may reduce audit findings through methodical review of county financial statements and reports, internal controls, compliance with various laws and regulations, and ethics policies. The establishment of effective audit committees should allow counties to promote transparency and accountability.

The majority of municipalities are also financially stable, though there are some with issues that relate primarily to revenue shortfalls and the need to cut expenditures or services.

The majority of municipalities are also financially stable, though there are some with issues that relate primarily to revenue shortfalls and the need to cut expenditures or services. The initial three-year implementation period of the Certified Municipal Finance Officer (CMFO) program, which was designed to help ensure municipal employees with financial responsibilities have appropriate qualifications, is now complete. This program is an unqualified success, with 206 individuals having received their CMFO certifications and high reviews from staff who have been certified.

Transparency and Accountability for Government (TAG)

The Transparency and Accountability for Governments in Tennessee (TAG) application developed by the Comptroller of the Treasury provides a quick look at where county government money comes from and where that money goes. Since 2010, TAG has allowed legislators, government officials, and the general public to view selected revenues and expenditures for county governments. The information available on the site has been taken from various schedules found in the 95 county annual financial reports prepared by the Office of the Comptroller of the Treasury, Division of Local Government Audit, and by certified public accounting firms.

The TAG application has now been enhanced to include debt information. The user-friendly resource now provides access to statistics on outstanding debt for each of the 89 counties audited by the Division of Local Government Audit. Users can drill down into a county's total debt to see the types of debt outstanding. Total debt figures are also available for the six counties audited by certified public accounting firms. Per capita debt amounts for all counties are available, as well as graphs that compare a county's debt to the state average for county debt.

The upgrade to the TAG application also includes an enhanced county-compare functionality that allows a user to evaluate revenue, expenditure, and debt information for up to 95 counties at one time. All of this information can be exported to Microsoft Excel for further analysis.

The TAG application can be accessed from the Comptroller of the Treasury website:
http://www.comptroller.tn.gov/TAG/tag.aspx.

Future Issues for Local Governments

The implementation of standards established by the Government Accounting Standards Board (GASB) regarding unfunded post-retirement benefits (health insurance and pensions) will have a negative impact on both county and municipal balance sheets. As employees age and healthcare costs rise, local governments will be forced to determine how these significant long-term liabilities will be funded and whether any changes to future retirement benefits are necessary.

There are far more questions than answers regarding the Affordable Care Act, and many cash-strapped states, cities, and counties remain uneducated as to the ramifications of the Act. Local governments are considering different types of healthcare packages to offer their full- and part-time employees in light of the prospect of having to spend thousands of dollars in new healthcare costs. These costs may significantly impact the budgets of some local governments.

The Council on Pensions and Insurance requested that the Treasury Department obtain actuarial data relative to governmental entities with defined benefit pension plans that are external to TCRS. This data has been accumulated and will be presented to the Council during the 2014 legislative session as part of a comprehensive review of local government defined benefit plans.

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