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, focusing on the condition of local governments.

The fiscal integrity of Tennessee state government remains sound.

- The current state budget, enacted by the General Assembly, and the budget proposed by Governor Haslam are balanced not only as required by Article II, Section 24 of the State Constitution, but also structurally.
- The state's per capita general obligation (GO) debt is not excessive and is among the lowest, if not the lowest, of all states.
- 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.

Tennessee is financially healthy in comparison to many other state governments. Our advantageous and somewhat unique financial position is in large part a result of the fiscal approach by the General Assembly in enacting budgets that have forgone, reduced, or eliminated expenses, as well as the ability of the administration to continue to streamline operations.

Revenue

After a period of significant revenue shortfall, Tennessee has begun to experience positive revenue growth. As of June 30, 2014, state revenue collections were under collected by almost $300 million. In the current year, revenue collections show a positive trend. The Funding Board projects general fund growth of between 3.85 and 4.20 percent for the current fiscal year and more modest growth of between 2.60 and 3.00 percent for next fiscal year.

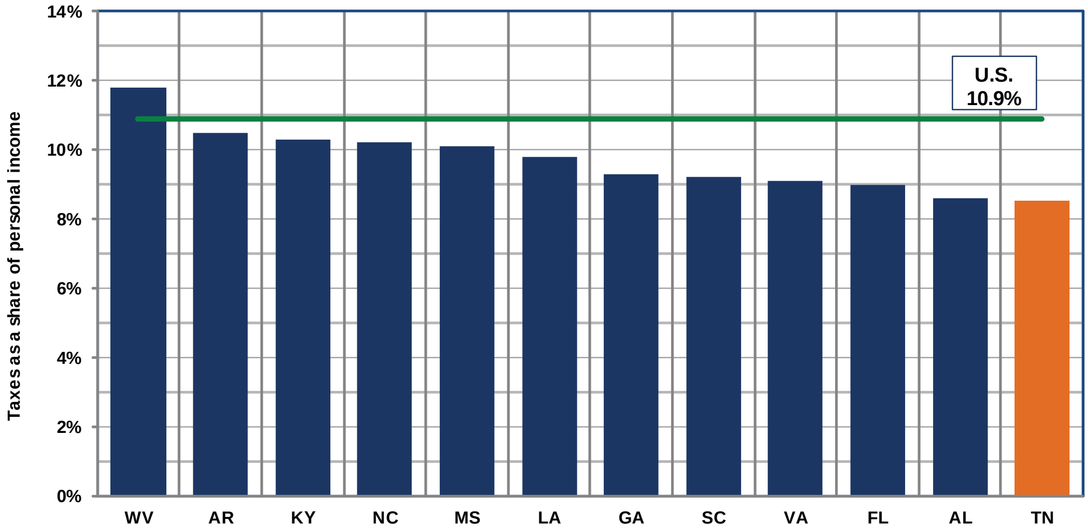
If the General Assembly cuts or eliminates a tax or creates a program, it must either increase another tax or cut an existing program.

Because over 80 percent of state general fund tax dollars go to education or health and social services, most revenue growth will be needed to fund these programs. The state should continue to plan on modest growth in the future. In short, on its current revenue streams, the state will be able to provide basic services to citizens, but likely not at current levels for every program. As a result, the General Assembly will have to make tough choices regarding existing programs, new government spending, and proposed tax cuts. If the General Assembly cuts or eliminates a tax or creates a program, it must either increase another tax or cut an existing program.

State Taxes

Tennessee is a very low-tax state. Measured as a percentage of personal income, Tennessee's state and local tax burden is 8.5 percent, which ranks Tennessee second behind South Dakota at 8.4 percent. Over the next few years, the General Assembly has the challenge of keeping Tennessee a low-tax state.

State and Local Taxes as a Percentage of Personal Income



Federal Funds

The Governor's proposed 2015-2016 budget presents a total state budget of approximately $33.3 billion. The budget is funded by approximately $15.1 billion in state appropriations, approximately $12.8 billion in federal funds, and about $5.4 billion from other revenue sources, such as tuition at state institutions of higher learning.

Tennessee operates a substantial number of programs with funding from the federal government, including Food Stamps, Temporary Assistance to Needy Families, Unemployment Insurance, Title I Education, and several environmental programs. Programs such as SNAP (food stamps) are funded almost entirely with federal funds and cost over $40 million per week, while others such as TennCare (the state's Medicaid program) require a state match. Almost all of the federal funds the state receives come with federal requirements. These requirements may be programmatic, require match, maintenance of effort (MOE), or a combination of these. These requirements reflect federal priorities that may or may not be the priorities of Tennessee or its citizens.

The federal debt increased to $18.22 trillion at the end of 2014, the third consecutive year that the federal debt has topped 100 percent of GDP. Federal debt is expected to grow to $19.0 trillion in 2015, exceeding 100 percent of GDP for the fourth consecutive year. Growing national debt may hinder long term economic growth.

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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 assurance, continue. Another example of federal promises not materializing is found in the Individuals with Disabilities Education Act (IDEA), where the federal government promised to pay 40 percent of special education expenses. In fiscal year 2014, the federal government funded approximately 16 percent. As federal spending continues to outpace federal revenues, federal funding of state-administered programs is at substantial risk of cuts or elimination.

These potential reductions or eliminations would cause substantial hardship. But the state must be extremely cautious before it uses state general funds to supplant any reduced federal funding.

Fuel Taxes

Tennessee relies heavily on fuel taxes to fund its highways and does not use debt financing, tolls, or general fund revenues. In the last several years, revenues dedicated to transportation have stagnated in Tennessee and across the country. Tennessee funds its state and local roads primarily with revenue from state and federal fuel taxes, which are assessed at a fixed rate per gallon of fuel. Tennessee's fuel taxes, like many other states, are not expected to be sufficient to maintain existing infrastructure and meet long-term transportation demands. Fixed-rate fuel taxes tie transportation revenue to the level of fuel consumption. Fuel consumption in 2012 remained below its peak in 2007 and is expected to continue to decline as a result of several factors, including:

- Increased fuel efficiency of vehicles,
- Higher fuel prices over the last few years,
- Demographic changes and preferences that have reduced the growth in vehicle miles traveled, and
- The increased use of alternative fuel vehicles, such as electric vehicles, which are not currently subject to highway fuel taxes.

From 2000 to 2013, population in Tennessee grew 14 percent and GDP increased 57 percent. However, Tennessee's fuel tax revenues have stayed relatively flat since 2000 in nominal dollars. From 1989 to 2012, inflation-adjusted fuel tax revenue has decreased 15 percent. The 20 cent per gallon gasoline tax set in 1989 had the purchasing power of 11 cents in 2012.

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Additionally, federal funds are a significant source of funding for highways, approximately 53 percent in fiscal year 2013. These federal funds are generated from federal fixed-rate fuel taxes, which mirror the stagnating revenue trends seen with Tennessee's fixed-rate fuel tax.

Information Technology

Established in 2012 in response to difficulties experienced in successfully completing information systems development projects, the Business Solutions Delivery Division (BSD) within the Department of Finance and Administration provides a centralized resource to manage large, complex information systems to support business objectives. BSD was formed to develop methodologies to enable the state to develop functional application systems on time and within budget. BSD staff are experienced in project management and other skills to help state entities develop systems to accomplish their business objectives.

Tennessee is preparing to implement a new driver's license issuance project, named A-List, which provides updated technology for driver license, ID, and handgun carry permit issuance and management. A-List is the first large project that was developed fully under the project management structure established by BSD.

While early indications on the A-List project are positive, another system, the TennCare TEDS (Tennessee Eligibility Determination System), was terminated in January 2015. Although BSD was not involved in the initial planning of TEDS, it was involved in the decision to end the contract with the vendor when it became clear the vendor could not meet the department's needs. Terminating TEDS means Tennessee did not spend additional funds on the system after it was clear that the objective could not be met with this contractor. TennCare still does not have an eligibility determination system, and the timeline for obtaining one has been extended while a new vendor is identified and gains footing on the project. There are similar situations in other state agencies, where systems failed to reach implementation, and the agencies are struggling to function with outdated systems.

Aside from the technical aspect of developing computer systems, there is a human aspect. Many systems today are "off the shelf," meaning that they are not customized to existing business processes. Users who have previously "always done it that way" are now forced to match their processes to the software. To accomplish this, particularly where the users may not be technologically agile, requires a strong training program, extensive user testing (with a broad cross-section of the user population), and an extended "troubleshooting" period as the system is implemented. The BSD Division is charged with providing support in these areas for large, complex projects. The Comptroller's Office is continuing to monitor system implementations and the influence the BSD Division has over them.

Status of Local Governments

The January 2015 issue of County Economic Tracker published by the National Association of Counties (NACO) found that 95 percent of county economies across the nation had not recovered to their pre-recession rates in the areas of unemployment, jobs, economic output, or median home prices. Furthermore, the study indicated that through 2014, many Tennessee counties had not recovered to pre-recession rates in these categories. Despite these troubling statistics, the financial condition of cities and counties in Tennessee is generally sound with the exception of a few local governments that are showing signs of financial distress.

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Currently, the Comptroller's Office is monitoring the budgets of at least seven counties and nine municipalities because of issues related to financial distress. In addition, the expenditures of two cities are under direct supervision.

While state revenues continue to show signs of steady improvement, local governments will need to continue conservative management practices and explore innovative ways to provide essential services to their citizens while considering ways cuts can be made to nonessential programs.

In addition to budget issues, local governments will face numerous other challenges related to education, finding qualified financial management staff, the issuance of debt, security, and financial statement reporting requirements that will require the presentation of unfunded liabilities associated with employee pensions and other post-employment benefits (OPEB).

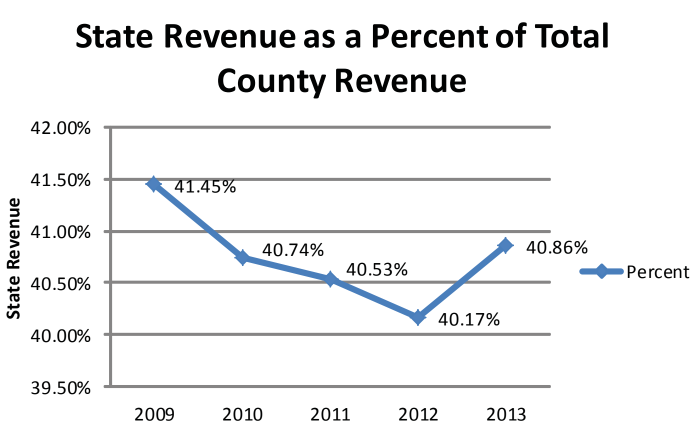
All local governments in Tennessee prepare financial statements in compliance with generally accepted accounting principles (GAAP). This is a tremendous accomplishment and makes Tennessee one of the few states to achieve this level of compliance.

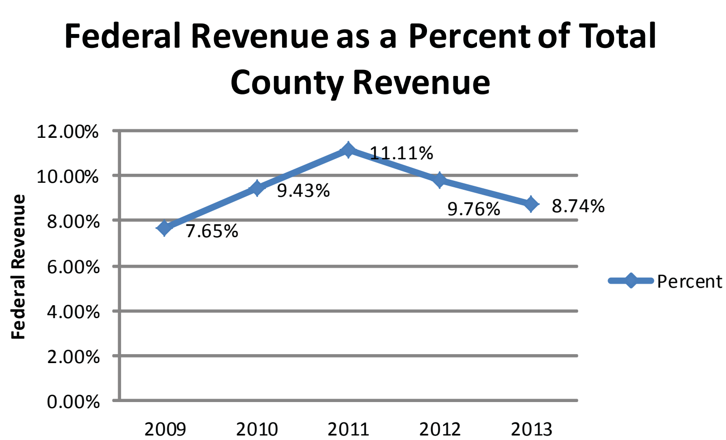
The Comptroller's Office will continue to assist in making local governments work as efficiently and effectively as possible while maintaining compliance with state laws and GAAP. The Comptroller will also continue to push for more transparency of financial activity and increased internal controls over financial transactions.

Financial Condition

Counties

Counties rely on property taxes as their primary source of funding followed by local option sales taxes and other taxes such as a wheel tax or hotel/motel tax to fund their operations. Counties, and especially school districts, also receive a significant portion of revenue from the state and federal government. State and federal revenues equal





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an average of over 50 percent of the total revenues of Tennessee counties. Should state or federal government revenues decline significantly, it would be difficult for many counties to find adequate revenue sources to support current services. Most of the state revenue is from the Basic Education Program (BEP) and gasoline taxes. Most of the federal revenue is in the form of grants with a significant portion of the grant revenues going to schools. The two graphs below present state and federal revenues as a percent of total county revenues for the last five years.

The steep increase in federal revenue between 2009 and 2011 is a direct result of the American Recovery and Reinvestment Act stimulus program.

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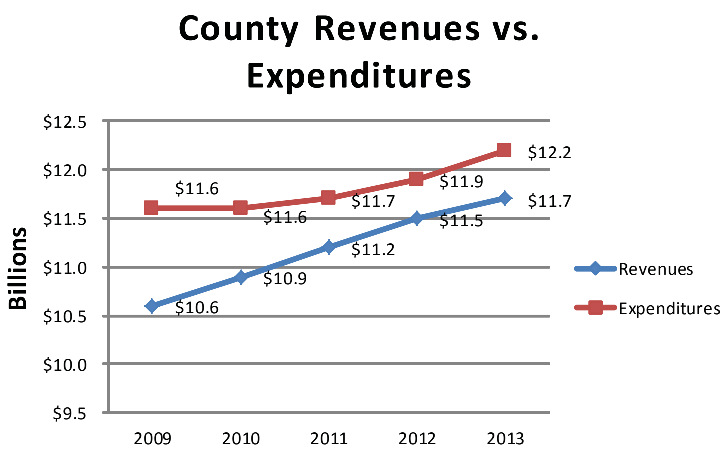
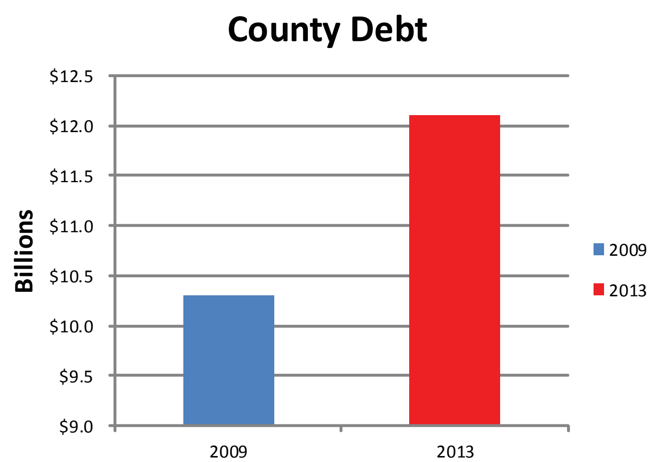
From 2009 – 2013, county debt has increased by over $1.8 billion. The debt represented in the graph below only includes institutional debt such as bonds, notes, and other types of loans. Counties also have other types of outstanding debt such as unfunded pension and post-employment benefit liabilities.





Cities

As with counties, most municipalities are financially stable, though many also suffer from declining revenues and the need to cut expenditures or services.

The Certified Municipal Finance Officer (CMFO) program is a success.

The Certified Municipal Finance Officer (CMFO) program is a success. As of June 30, 2013, 386 CMFOs were registered with the Division of Local Government Audit. As of December 31, 2014, only 36 of the registered CMFOs had not met the continuing professional education qualifications or had chosen not to renew their CMFO certification, and only a handful of municipalities were without a CMFO.

Documented Internal Controls

Most local governments do not have formal internal control policies and procedures and the Comptroller's Office writes numerous findings as a result of these poor internal controls. The Financial Integrity Act of 1983 currently addresses state agencies. The Act requires state agencies to "establish and maintain internal controls." Fraud and errors in financial reporting are more likely to occur when there is a weak or ineffective internal control system. Implementing a system of internal controls is a best practice to ensure the financial integrity of local, state, and federal funds handled by local governments. All governments that receive federal grants are required to have a system of internal control.

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Audit Committees

Ninety-three of 95 counties have established audit committees. Many of these committees were established to comply with the Department of Economic and Community Development's Three Star Program. The Comptroller is monitoring these committees to ensure they are active committees fulfilling their responsibilities as set forth in their enabling resolutions. Audit committees should provide independent review and oversight of the government's financial reporting processes, the government's internal controls, and a review of the external auditor's report. The audit committee is also tasked with following up on corrective action and compliance with issues noted in the audit reports.

Challenges

Unfunded Long-term Liabilities for Pensions and Other Post-Employment Benefits (OPEB)

Actuarial studies performed for the year ended June 30, 2013, indicate that county governments were obligated for billions of dollars of unfunded pension and OPEB costs. Most OPEB liabilities relate to health insurance provided to retirees. Unfunded pension costs amounted to approximately $2.2 billion. Unfunded OPEB costs amounted to approximately $4.0 billion. Similarly, actuarial studies indicate that municipal governments were obligated for millions of dollars of unfunded pension costs. Unfunded pension costs amounted to approximately $588 million. Data was unavailable, but it is likely that the unfunded OPEB costs, for those municipalities that provide OPEB benefits, will be greater than the pension liability. These amounts are currently not recorded on the balance sheets of local governments, but new standards from the Governmental Accounting Standards Board (GASB) will require them to be recorded. When this occurs, some local governments will likely have a deficit in net position (i.e., government net worth). In the future, local governments will have to carefully consider the costs of providing benefits to employees because a liability will be recorded for each promise made.

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Utilities

Tennessee has 183 utility districts and approximately 195 municipal utility departments. As of December 31, 2014, 17 of the utility districts and 33 of the municipal utility departments are considered to be financially distressed. In addition, another 6 of the utility districts and 17 of the municipal utility departments are being reviewed for excessive water loss.

Security

Another challenge for local government is the constant threat of cyber-attacks on their computerized accounting, payroll systems, and personally identifiable information. In addition, physical security for buildings and personnel is becoming a matter of increasing concern given the radical nature of certain individuals and organizations in the world today. Many local governments have little security on either front.

Emerging Issues

Tax Abatement Disclosures

The Governmental Accounting Standards Board (GASB) is proposing a standard that would require significant disclosures concerning government tax abatements. This would affect reporting for both state and local governments. Tax abatements are commonly known as tax incentives or in-lieu-of tax agreements. For purposes of the proposed standard, a tax abatement is defined as an agreement entered into by a government and a taxpayer in which the government promises to forego tax revenues and the taxpayer promises to subsequently take a specific action that contributes to the economic development or otherwise benefits the government or its citizens. The proposed standard would require disclosures of all tax abatement agreements in the notes to the audited financial statements. General information about the number and types of agreements would be required. In addition, the dollar amount of all tax abatements (i.e., the amount of taxes that were not collected) for a given year would be reported. It remains to be seen what impact this proposed standard may have on the way tax abatement agreements are negotiated.

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Municipal Chart of Accounts

The Comptroller's Office is working with the cities and its organizations to create and implement a uniform chart of accounts for municipalities. Section 9-2-102, Tennessee Code Annotated, gives the Comptroller's Office the authority to, "prescribe a uniform system of bookkeeping designating the character of books, reports, receipts, and records, and the method of keeping same, in all state, county, and municipal offices, including utility districts, which handle public funds." A uniform chart for counties was created in the mid 1980s and is currently being used in 91 of the state's 95 counties. The county uniform chart of accounts was an innovative development that enabled counties to maintain a standardized set of accounting records, allowing them to more accurately track financial activity, easily create budgetary presentations, and provide for more transparent communication of fiscal matters to citizens and local officials. A county uniform chart of accounts has also enabled the Comptroller's Office to standardize audit programs, develop auditing software, and easily post county revenues, expenditures, and debt information to the Transparency and Accountability for Governments (TAG) website.

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The first questions asked by the credit rating agencies, Fitch, Moody's, and Standard & Poor's, was about the fiscal health of Tennessee's local governments. Standard & Poor's gave Tennessee a very strong transparency rating in a recent report saying "In our view, these local governments operate within a framework that requires very strong transparency and comparability of financial information." Not only will a uniform chart of accounts help with accuracy and comparability of financial documents, but also will help assist the state to maintain its sterling credit rating.

Property Assessments

Due to the reappraisal system that requires counties and cities to update their property values to market value on a 4, 5, or 6 year cycle, the year to year trends are not always clear. Over the past couple of years, the Comptroller's Office has noticed an overall slow, but steady, up-turn in property values as compared to the steep declines experienced from 2007 to 2010. Forty-four of Tennessee's 95 counties have completed county-wide reappraisals over the past 24 months. While the results do not indicate that all markets in Tennessee have returned to their pre-crisis value levels, the recent trends are mostly positive.

Due to the Great Recession, many jurisdictions had to make the tough choice to raise taxes or decrease the amount of services provided to citizens. Out of 95 counties, 77 chose either to not change or decrease their rates. There are many reasons for their decisions, including, but not limited to, a desire by citizens for fewer services instead of higher taxes; growth of the counties tax base; or no current need for new capital projects.

Under normal conditions, jurisdictions have enjoyed annual increases in local tax revenue from new construction. The stagnant economy during the Great Recession diminished these increases. This trend has also seen a reversal as sales volumes of both existing homes and new construction are increasing from year to year in most areas of Tennessee. In addition, over the past four years, foreclosure activity in Tennessee has fallen dramatically. The state ranks 42 in the nation in terms of foreclosure rates and is experiencing the lowest level since mid-2007. Overall, indications are that there is an end in sight to the fiscal impact of the down economy and the housing bubble crisis in particular for counties and cities from a property tax revenue perspective.

Conclusion

Tennessee is truly a blessed state with sound finances and low taxes. Our state has a rich cultural heritage. Generally speaking, citizens enjoy a quality of life in Tennessee that is not found in other states. If Tennessee is to retain its financial integrity with very low taxes, it is essential that the General Assembly act carefully to balance the effects of creating any new programs or eliminating existing taxes.

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