Comptroller of the Treasury

Quarterly Fiscal Affairs Report

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State law directs the Comptroller to report on the state's fiscal affairs every quarter. In this report, we provide a global look at Tennessee's fiscal affairs.

The fiscal integrity of Tennessee state government remains strong.

- The current state budget, enacted by the General Assembly, is truly balanced – both structurally and as required by Article II, Section 24 of the State Constitution.
- The state's per capita general obligation (GO) debt is not excessive and is among the lowest, if not the lowest, of all states.
- The state has budgeted on a recurring basis to ensure that principal and interest on state-issued bonds continues to be paid on time.
- The state's retirement plan is sound.
- The post-employment benefit (OPEB) obligation for our retirees is manageable, and its unfunded liability has decreased by approximately $500 million since June 30, 2010.
- The state's unemployment trust fund is appropriately funded.

Tennessee's positive financial position is largely attributable to the General Assembly's fiscal approach. The General Assembly has enacted budgets that forgo, reduce, or eliminate expenses, and the administration has continued to streamline operations.

Past Reforms

In the last few years, the state has made several reforms that will save money in future years. The state has:

- reformed its laws relating to debt obligations of the state, creating a model for the nation;
- reformed its pension plan for its employees and teachers to ensure they will receive the benefits promised;

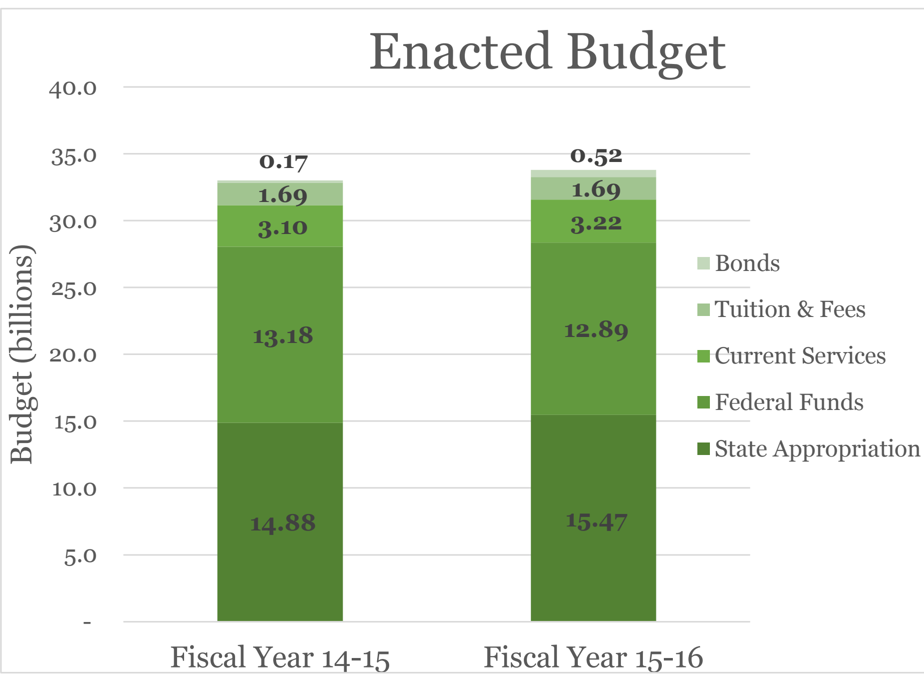
- reformed and dramatically reduced the state's OPEB obligations;
- reformed its franchise and excise taxes, not only to provide stability, but also to protect Tennessee businesses; and
- reformed hiring and personnel practices and policies.

These reforms did not involve large additional appropriations, but will have positive financial implications for years to come. The state did make substantial appropriations of state funds in order to:
- build up reserves, particularly the Rainy Day Fund;
- perform much overdue maintenance of state buildings; and
- make capital improvements to reduce energy costs and consumption.

Most importantly, the state directed substantial funds to its stated priority: education. Tennessee is in the process of fundamentally reforming education, and was one of a very small number of states to consistently increase K-12 funding during the last few years.

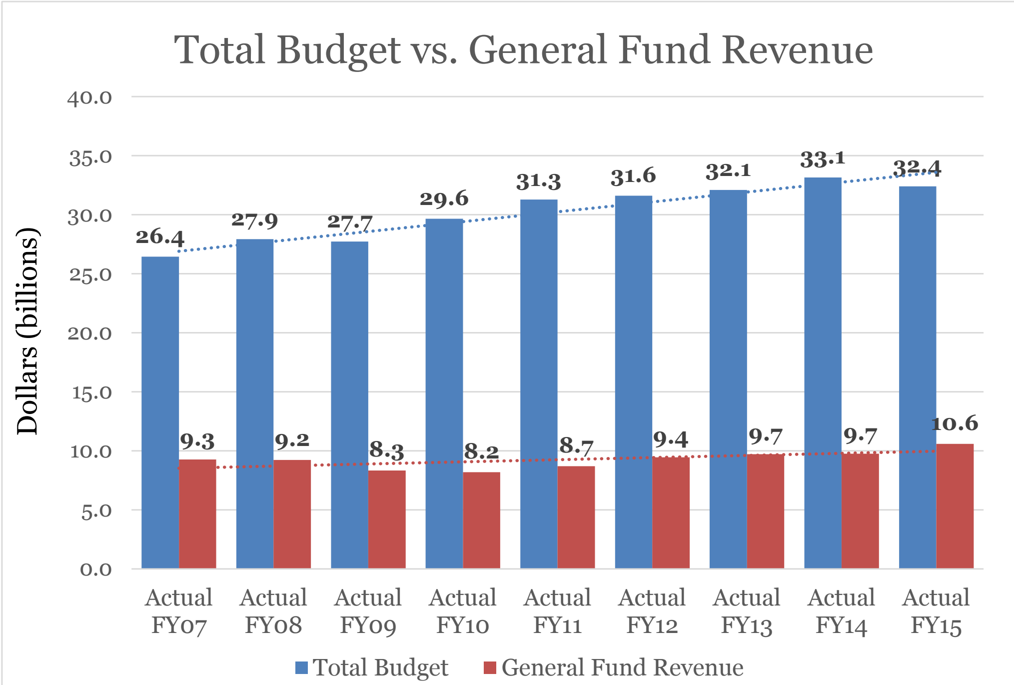
Budget

As enacted, Tennessee's budget for the current year is approximately $33.8 billion. State appropriations make up roughly 45.9 percent, while federal funds comprise nearly 38.2 percent of the total budget.



TennCare, the Basic Education Program, higher education, and transportation make up approximately two-thirds of the total budget.

Tennessee's priorities are reflected in its expenditures: appropriations for TennCare, the Basic Education Program, higher education, and transportation make up approximately two-thirds of the total budget. As the General Assembly begins deliberations about the spending priorities for the 2016-2017 budget, consideration should also be given to whether, and to what degree, previously appropriated funds have been spent effectively. The General Assembly is responsible for making this judgment.



Federal Funds

While this report focuses on state appropriated funds, a global look at Tennessee's fiscal affairs should also take note of federal funding.

Out of Tennessee's total budget of approximately $33.8 billion for fiscal year 2015-2016, roughly $12.9 billion are federal funds. Almost all of the federal funds Tennessee receives have federal requirements: they may be programmatic; require a state match; require that the state continue funding at its current level, despite the addition of federal funds (maintenance of effort); or a combination of these. These requirements reflect federal priorities that may or may not be the priorities of Tennessee or its citizens.

Federal funds also carry risk. As we recently saw in the Build America Bond program, federal assurances of continued promised funding do not always materialize, although the local government obligations, which rely on the federal assurance, continue. The Individuals with Disabilities Education Act (IDEA) is another example of federal promises not materializing. Originally, the federal government promised to pay 40 percent of special education expenses; in fiscal year 2015, however, the federal government only funded about 16 percent.

The potential reduction or elimination of federal funding in certain areas makes budgetary decisions in Tennessee even more challenging. Proposals to use state general funds to replace any reduced federal funding should be closely examined, since federal funding constitutes such a significant percentage of Tennessee's total budget. Replacing federal funding with state funding could result in significant cost increases to the state. For example, food stamps cost approximately $40 million per week; TennCare costs about $28 million per day, about two-thirds of which are federal funds. And, unlike the State of Tennessee, the federal government can use debt to finance the difference between expenditures and revenues.

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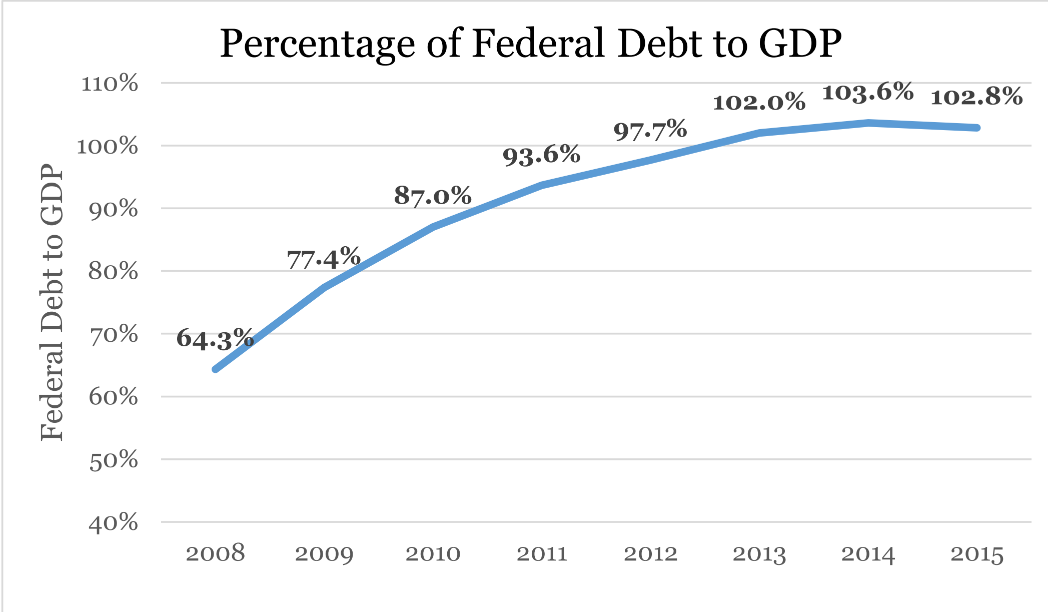
The state must be mindful that federal funds are a risk – among the first things the federal government might reduce or eliminate is aid to states.



Low Taxes

Tennessee is a very low tax state by almost any measure. In 2013, for example, Tennessee ranked as the second-lowest state in the nation for taxes as a percentage of personal income.

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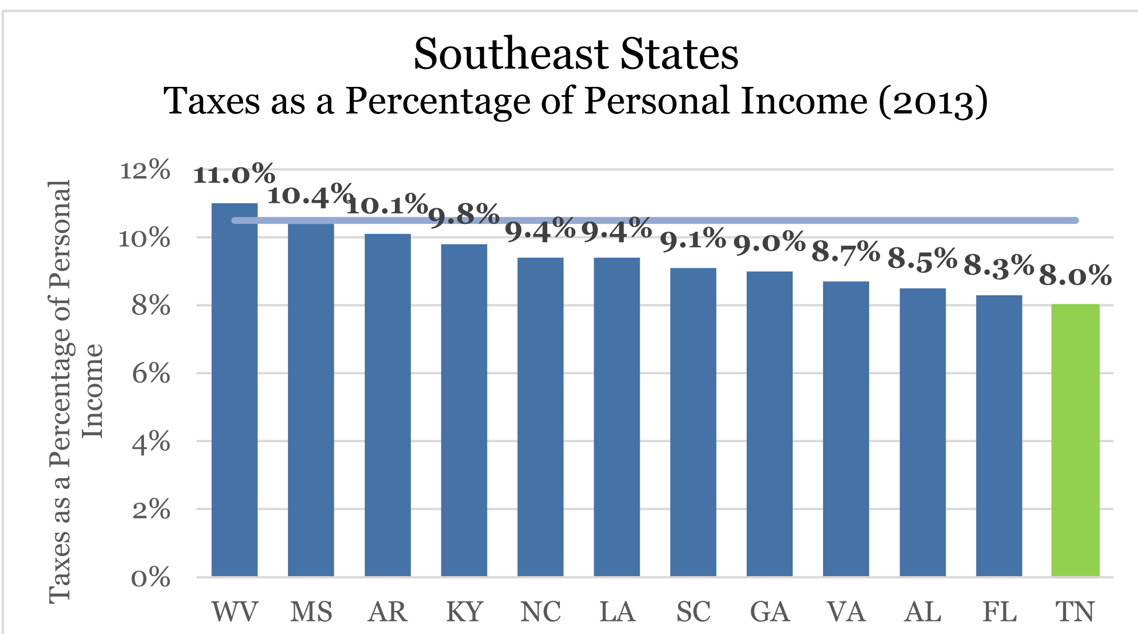
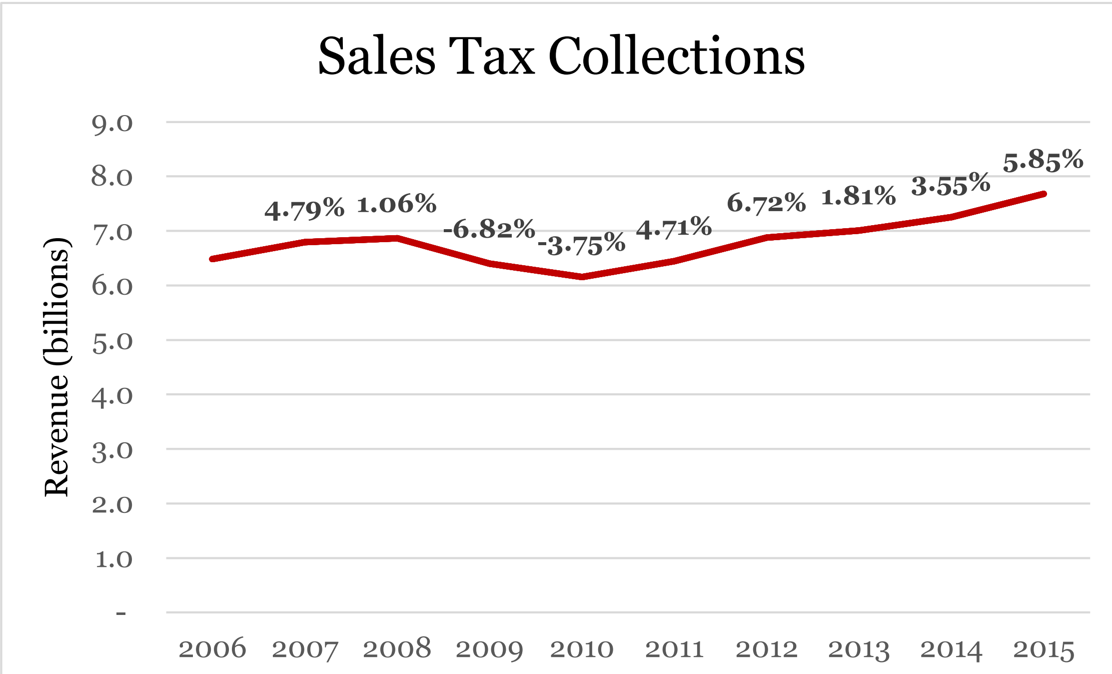


Only South Dakota is lower.

Revenue

In fiscal year 2014-2015, Tennessee collected more revenue than originally projected; so far, it appears we may exceed revenue estimates again this fiscal year.

The state's largest source of revenue is the sales tax, which is generated primarily from tangible personal property. Sales tax revenues are considered "inelastic," meaning they do not grow as quickly as the state's economy as a whole.



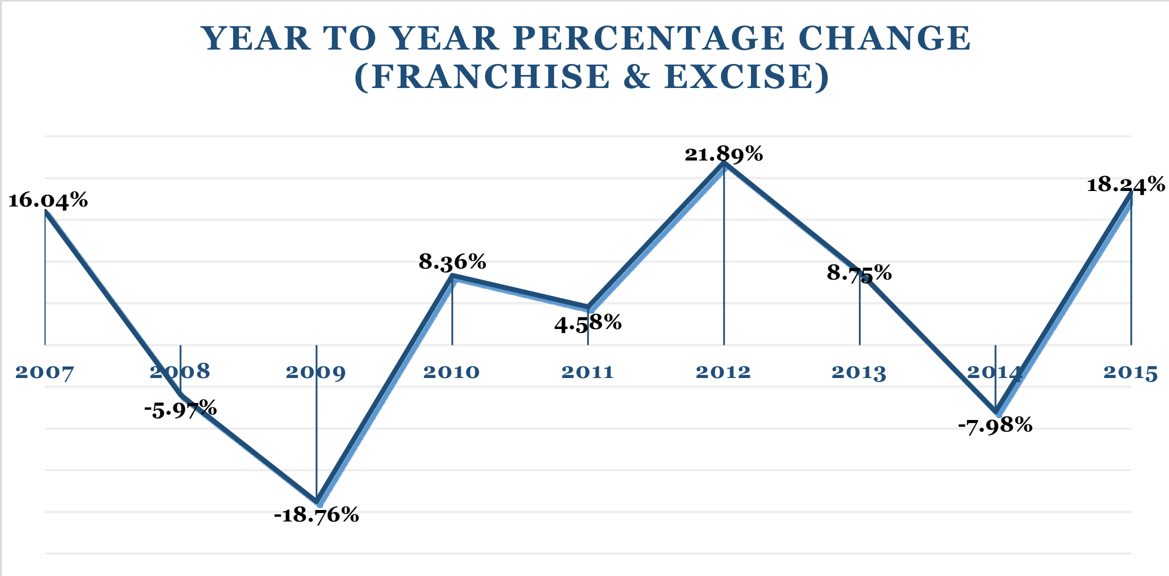
Over the past ten years, sales tax revenues have remained fairly stable. The biggest fluctuation took place during the financial crisis, where collections decreased 6.82 percent from 2008 to 2009. Revenue increased most sharply from 2011 to 2012, rising by 6.72 percent. Because the cost of core services grows faster than state revenue, the state must not create new programs or expenditures without offsetting reductions.

Sales tax revenues have remained fairly stable.

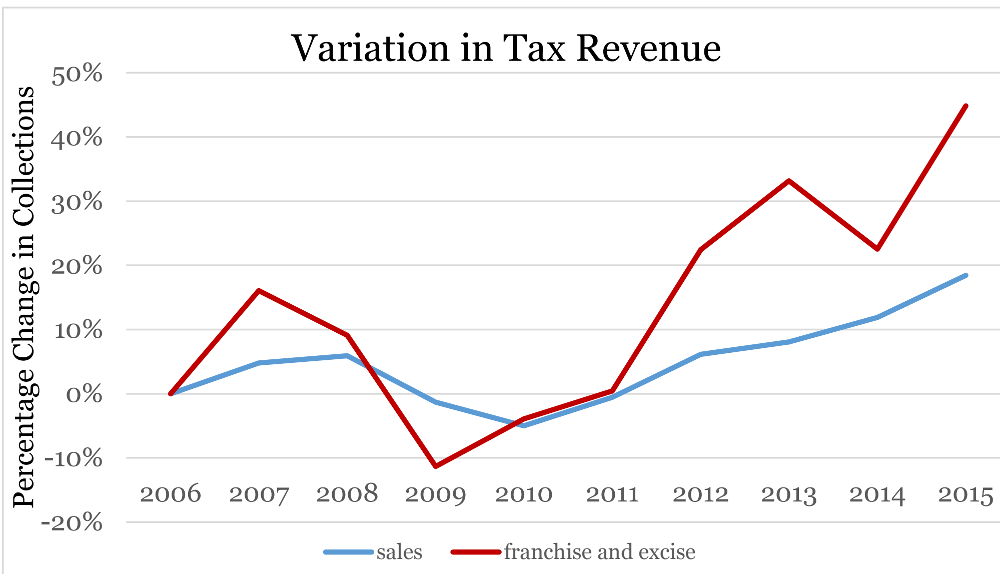
Franchise and excise tax collections are volatile.

The state's second largest source of revenue comes from franchise and excise taxes. Unlike the sales tax, franchise and excise tax collections are volatile and fluctuate along with the business cycle.

From 2008 to 2009, franchise and excise collections dropped by 18.76 percent – in comparison, the sales tax decreased by 6.82 percent. From 2011 to 2012, franchise and excise revenues increased by 21.80 percent. Sales tax collections increased by 6.72 percent over the same period.



The General Assembly had the foresight to reform franchise and excise taxes last session. While these reforms raised revenue, their primary purpose was to protect the tax base and provide stability during economic variations. Nevertheless, even with these changes, franchise and excise taxes remain largely dependent on the business cycle.

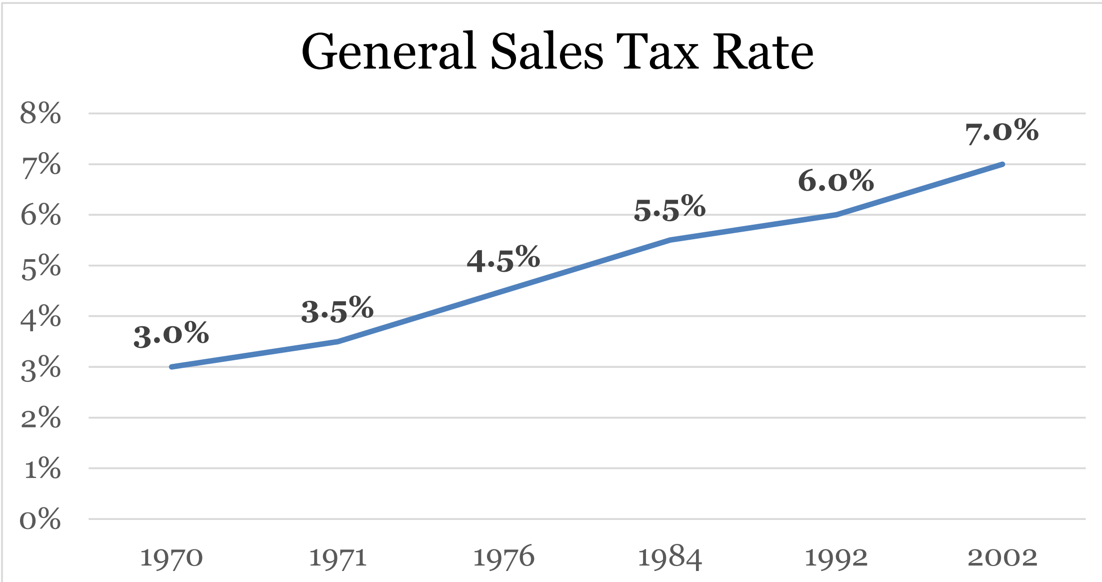


The Challenge

In short, the challenge for the General Assembly is to determine how to use our increased revenue: we must protect Tennessee's fiscal integrity and reduce, not create, future liabilities. We must also be careful to not cut taxes without a corresponding reduction in expenditures.

If the state's financial history is any guide, the cost of providing our existing government services will eventually exceed tax revenues collected at our current rates. *Since the 1960's, Tennessee's primary source of revenue has been the sales tax. As the cost of government operations increases, the General Assembly has raised the sales tax rate every 6 to 8 years to continue providing the same services. It has not raised the sales tax in the last 14 years.*

With the sales tax at 7 percent, plus a local option of up to 2.75 percent, Tennessee's combined sales tax approaches the Biblical tithe of 10 percent, making further increases problematic. The challenge is to manage *existing* resources while meeting state priorities: we must control the costs of our core services, and reduce or eliminate services that are not priorities.



In the current year and, according to projections, the coming fiscal year, the state appears to have the money to fund its existing services, and perhaps some left over. This is a rare opportunity – with tax revenues higher than projected, the state can preserve its fiscal integrity and reduce the risk of future tax increases.

Adequate reserves are a key component of fiscal integrity.

Adequate reserves are a key component of fiscal integrity. However, rating agencies have noted that the state's Rainy Day Fund balance is not ideal, and that franchise and excise taxes have varied widely from budget projections. Meaningful additions to our reserves would strengthen our financial safety net, cushion us against revenue fluctuations and economic downturns, and further enhance the state's fiscal integrity.

The General Assembly may also use the available funds to increase government efficiency, reduce future costs, and lower the risk of catastrophic loss. This may include appropriations for system replacements, information technology, cybersecurity, overdue capital maintenance, and infrastructure. Additionally, the General Assembly may also spend the increased revenue on one-time capital projects that are truly state obligations, but difficult to fund in most years. When making additional investments in key government functions, the state must continue to prioritize efficiency in operations and evaluate the results of past and current investments for evidence of effectiveness.

Care should also be taken to ensure any new budgetary commitments are financially sustainable.

Care should also be taken to ensure any new budgetary commitments are financially sustainable; the state's fiscal history offers numerous examples of the serious problems that arise when recurring expenses are paid for with nonrecurring funds. Always present is the temptation to commit one-time surplus revenues toward recurring obligations, but such commitments can be difficult to maintain during economic downturns. Spending decisions may have long-term consequences, and adherence to sound budgetary practices reduces the likelihood of significant cuts to government services and tax increases to close budget deficits in future years.

Reducing or eliminating an existing tax, such as the Hall income tax, may be appealing at this point. However, it is imperative to do so by reducing or eliminating the cost of existing programs in future years, rather than using estimated revenue increases that may not be realized. Over time, the cost of providing essential core services outpaces the growth in taxes. As such, it is irresponsible, if not a blueprint for disaster, to cut or eliminate a tax based on presumed future growth.

Conclusion

Tennessee has a conservative fiscal approach, low debt levels, and excellent pension funding. This, combined with the state's history of balanced budgeting – including setting aside recurring funds to pay for state debt and planning ahead for debt that has not yet been issued – assures investors and rating agencies that the state has solid credit.

This year's revenue projections are quite positive. Tennessee has the rare opportunity – both through the legislature and the executive branch – to make structural improvements and reforms. These reforms will benefit the people of Tennessee by providing stability, predictability, and risk avoidance for decades to come, without a fiscal crisis. To do this, the state must continue to emphasize efficiency in its operations and avoid budgetary decisions that make commitments for future years without the recurring funds to pay for them.

This year, Tennessee can do what few, if any, democratically elected governments in the world have done: our General Assembly can think beyond the next election and focus on what is truly best for our taxpayers.

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