THE SYCAMORE INSTITUTE

BUILDING A STRONGER TENNESSEE THROUGH DATA AND RESEARCH

TENNESSEE STATE BUDGET PRIMER

A FOUNDATION FOR UNDERSTANDING OUR STATE'S PUBLIC POLICIES

December 2016

THE SYCAMORE INSTITUTE

Dear Friends and Fellow Tennesseans,

It is our pleasure to present to you the Sycamore Institute's first Tennessee State Budget Primer. We hope this report – the information, the graphics, and the discussion – will demonstrate our commitment to putting reliable data and research in the hands of our state leaders, policymakers, and the general public.

Our bipartisan board of directors brings together a wide range of political perspectives bound by a shared vision of a healthy and prosperous Tennessee. We believe in data-driven decision-making and the value of robust debate to guide our progress toward that vision.

The state Budget is one of the most significant pieces of public policy our General Assembly enacts every year. Understanding what's in it and how it works is important, but many simply don't have the time or resources to explore the historical trends, break down the numbers, or unpack the process as we have in the attached pages.

We hope you will find value in this primer and our future projects in the coming months and years. We welcome your feedback and hope you will take the time to connect with us and tell us how we can support your work.

Sincerely,

Jim Bryson
Board Chair

Laura Berlind
Executive Director

THE SYCAMORE INSTITUTE

BUILDING A STRONGER TENNESSEE THROUGH DATA AND RESEARCH

Launched in 2015, The Sycamore Institute is an independent, nonpartisan public policy center for Tennessee. The organization's mission is to provide accessible, reliable data and research in pursuit of sound, sustainable policies that improve the lives of all Tennesseans.

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Downloadable graphics, a glossary of key terms, notes about our methodology, and more are available on our website.

WWW.SYCAMOREINSTITUTETN.ORG

SUGGESTED CITATION:

The Sycamore Institute, "Tennessee State Budget Primer: A Foundation for Understanding Our State's Public Policies," 2016.

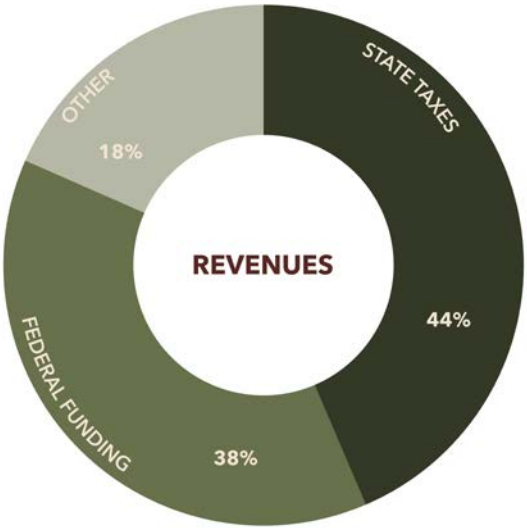
TENNESSEE STATE BUDGET

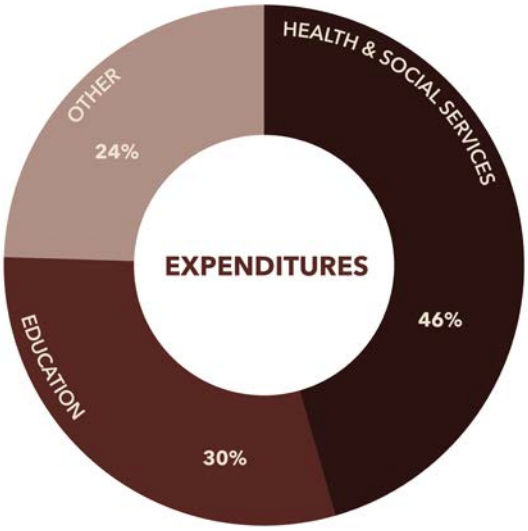
WHAT IS THE BUDGET?

The Budget is an accounting of all the money coming into and going out of the state government. It is also a statement of public policy priorities and a vision and direction for the state.

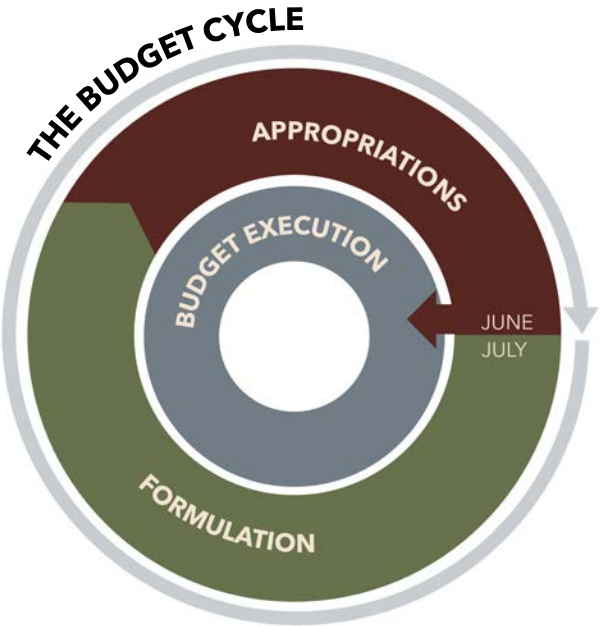
Tennessee's constitution requires a balanced budget.

FY 2016-2017 RECOMMENDED BUDGET
$34.8 BILLION

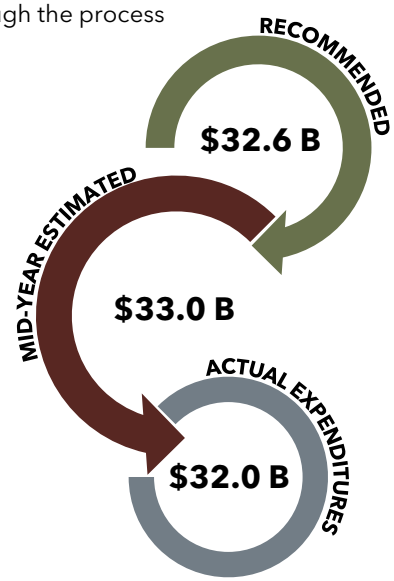




HOW IS IT DECIDED?



FY 2014-2015 BUDGET
through the process



SAVINGS

23 DAYS

the number of days the state government could function with expected rainy day fund and TennCare reserve balances

KEY FACTS

55%

of state tax dollars are collected through the general **SALES TAX**.

Three out of every four **FEDERAL DOLLARS** coming into Tennessee are spent on health and social services.

1 OF 9

states with little or no income tax

HIGHEST state and local sales tax rate in the country

#3 LOWEST per capita total state taxes in the country

$394 MILLION

the size of the **BUDGET SURPLUS** at the end of FY 2014 - 2015

18%

of the General Fund was considered "**DISCRETIONARY**" in FY 2015-2016.

KEY FINDINGS

Tennessee's Budget is a financial representation of the common goals we want to achieve for our state, the public goods and services that we all need to help us meet those goals, and how we raise the money to pay for them. The purpose of this document is to shed light on the dynamic processes that are used to create and guide Tennessee's Budget, to provide a picture of where we are and where we've been, and to illuminate the difficult trade-offs policymakers face in making budget decisions. The ultimate goal is for the state's budget decisions to support the health and well-being of Tennesseans through thoughtful planning and informed stakeholder engagement.

HIGHLIGHTS

Of the Governor's $34.8 billion FY 2016-2017 recommended Budget, over three-quarters (76%) is spent on health and social services and education (46% and 30%, respectively). The money to fund the Budget's activities comes primarily from the state's own taxes (44%) and federal funding (38%).

The Sycamore Institute's coverage of Tennessee's state Budget is ongoing. Visit our website to sign up for alerts of new reports and more analysis of the Budget.

www.sycamoreinstituteTN.org

PROCESS

- The state's fiscal year (FY) spans July 1 to June 30.
- The state constitution requires that the Budget be balanced (i.e. spending can't exceed revenue collections and reserves in any given fiscal year). In order to meet this requirement, the Budget is often dynamic – changing throughout both the planning and actual spending phases as estimates of revenue collections change.
- The starting point for the Governor's Budget recommendation to the Legislature each year is the prior year's recurring base budget. The Governor's recommendation is the starting point for the Legislature's work.
- In order to respond to unexpected needs throughout the year, the Legislature gives the Executive Branch flexibility to manage the Budget and to spend less to keep the Budget balanced. Because of this, the "actual" numbers shown in the Budget for the prior year do not always lend themselves to direct comparisons with the other two years.

EXPENDITURES

- While the overall Budget is dominated by health and social services, only 27% of the state's own dollars are spent on this purpose. The biggest chunk of state dollars (40%) is spent on education.
- Federal dollars are overwhelmingly spent on health and social services (77% of all federal dollars in the state Budget).
- Health, social services, transportation, and economic development programs and activities are predominantly funded by federal dollars, while education, law, safety, and corrections programs and activities are largely funded by the state's own dollars.

REVENUES

- The sales tax is Tennessee's largest source of state tax dollars (55%). The state and local rate in most counties is 9.75%, while the average state and local rate is about 9.5%. This is the highest average rate in the nation.
- Tennessee is one of nine states with little or no individual income tax. The state's only income tax – the Hall Income Tax, a tax on investment income – was put on a path to elimination by 2022 in the 2016 legislative session, and the state constitution bars any new state earned income taxes.
- Although the state Budget's reliance on federal funds is less today than it was during the most recent recession – the most severe since the Great Depression – Tennessee relies more on federal dollars than all but three states.

- Much of the state Budget has strings attached – including programmatic and/or state matching fund requirements that come with federal dollars, earmarked purposes for many state taxes, or funding requirements that result from lawsuits against the state.

RAINY DAY SAVINGS & SURPLUSES

- Tennessee could fully cover state government operations at current Budget funding levels for around 23 days solely with rainy day and TennCare reserves. This amount is less than what was on hand going into the Great Recession, and some believe another recession could be around the corner.
- At the end of FY 2014-2015, rainy day savings and TennCare reserves totaled $759 million, while unspent appropriations and overcollection of taxes totaled $873 million, which included $479 million reserved for FY 2015-2016 and $394 million in surplus.

NOTABLE STRENGTHS

- **RESPONSIBLE SAVING**: Tennessee follows most best practices when it comes to saving for a rainy day – including having a defined purpose in law, setting a target balance, and having rules for replenishment.

- **TENNESSEANS' TAX LOAD**: Tennesseans enjoy a low state tax load. At about $2,200 per Tennessean, the state tax load is the 3rd lowest in the country.

POTENTIAL AREAS FOR IMPROVEMENT

- **TOOLS FOR LONG-TERM PLANNING**: Tennessee does not publish long-term estimates of revenue collections and potential spending needs, tools that can help states plan for the future, invest and save adequately, and identify any structural problems.

- **SALES TAX MODERNIZATION**: Over the last two decades, people have changed how and on what they spend their money – shifting from physical stores to online merchants and from goods to services. Like many states, Tennessee's sales tax hasn't always evolved with these changes and, as a result, is expected to capture fewer and fewer purchases over the coming years.

- **TIMELY FUNDING INFORMATION**: While one fiscal year ends in June and the Budget for the next year is usually passed by the Legislature in April, reliable estimates of actual expenditures and mid-year estimated Budgets for programs usually aren't publicly available until the next January when the Governor's recommended Budget is released.

WHAT IS THE STATE BUDGET?

AN ACCOUNTING OF ALL THE MONEY COMING INTO AND GOING OUT OF THE STATE GOVERNMENT

A STATEMENT OF PUBLIC POLICY PRIORITIES AND A VISION & DIRECTION FOR THE STATE

The state's Budget is an accounting of all the money coming into and going out of the state government. The money going out is all of the state's **expenditures** – spending on everything from the costs of building and maintaining highways and roads to the salaries and benefits of the state employees that help run these programs. The money coming in is the state's **revenues** – all of the ways that the state government receives money, whether it's sales tax dollars or grants from the federal government.

Perhaps more significantly, however, the Budget also represents a delicate balance where all the pieces work in concert to achieve public policy goals. The Budget reflects a vision and direction for the state. The Sycamore Institute's interest in public policies that impact Tennesseans' health and well-being requires an understanding of the Budget.

Tennessee invests more on health and social services activities than any other service area. Nearly half of the Budget, in fact, is dedicated to health and social services. The state's constitution requires that the Budget be balanced wherein expenditures are no more than revenues and reserves in any year. The state's Budget is finite, which means that spending decisions within the Budget for one program affect the dollars available for other programs. Consequently, the Budget represents the relative public policy priorities of the Governor and the Legislature within limited resources.

Furthermore, decisions about how to raise (or lower) the dollars needed to fund the government's programs also influence health and well-being. Budget decisions impact the amount of money Tennesseans have to pay for the things they need for themselves and their families. They can also create incentives for certain behaviors or actions.

THE BUDGET AT WORK[1]

Nearly 996,000 students were educated by 63,000 teachers in Tennessee's public schools last year.

The Department of Transportation is responsible for over 95,000 miles of public roads.

The Department of Environment & Conservation oversees 200,000 acres of public land in 56 State Parks and 85 Natural Areas.

Almost 1.5 million low-income and disabled individuals receive health care through TennCare.

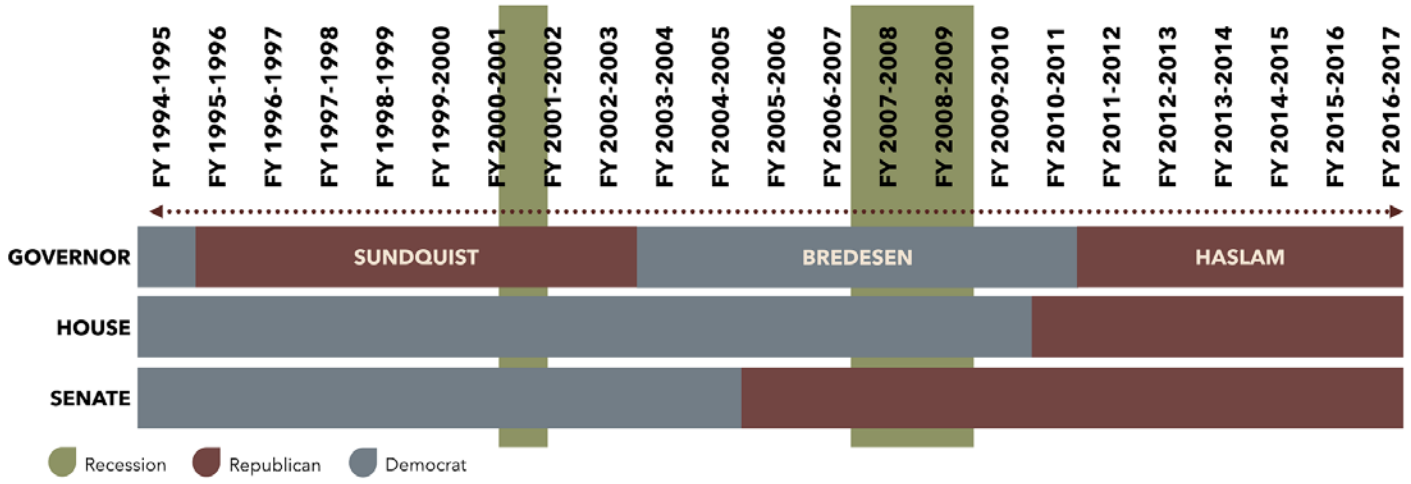
BACKGROUND

METHOD: Unless otherwise noted, all Budget data were obtained from the relevant year's Budget document. For historical trends, FY 1994-1995 is used as the starting point for two reasons. It captures not only the prior two governors' terms but also the life of TennCare, which began in 1994 and is the single largest item in the Budget today.

All historical data for FY 1994-1995 through FY 2014-2015 represent actual expenditures obtained from the relevant year's Budget document. FY 2015-2016 data are mid-year estimated budget numbers and FY 2016-2017 are recommended budget numbers – both obtained from the FY 2016-2017 Budget document. Although FY 2015-2016 has ended and the General Assembly passed appropriations for FY 2016-2017, these numbers are used because the Budget document is the most reliable source of publicly-available information about these years (as discussed on page 36). For the reasons discussed beginning on page 11, these numbers are not considered comparable to historic actual expenditures.

CONTEXT: The Budget is inextricably tied to both politics and the economy. To understand some of the historical trends, it's important to understand the political and economic context. The figure below provides additional information about the state's governors, political majorities in the House and Senate, and the timing of recessions during the span covered throughout this document.

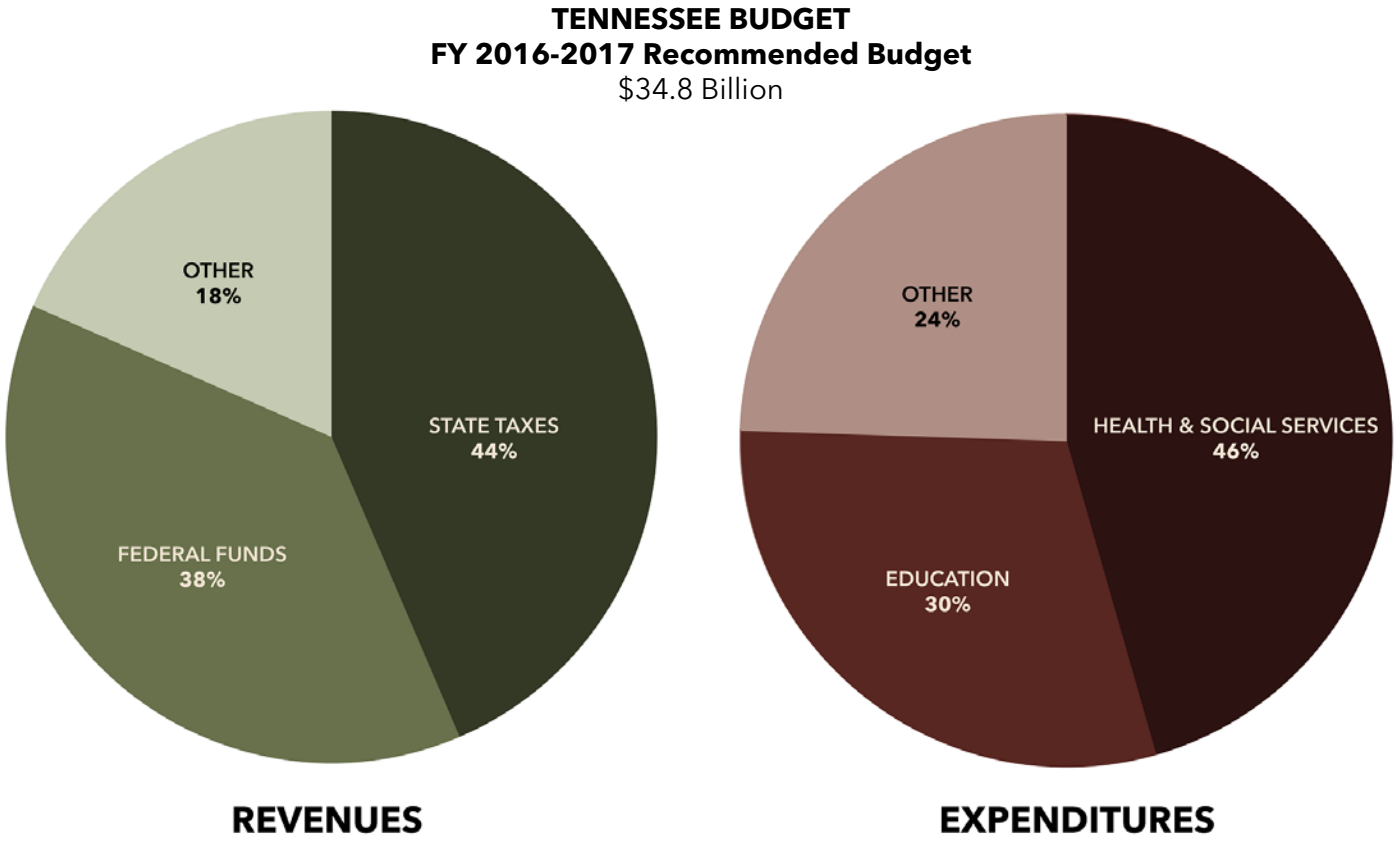
POLITICAL & ECONOMIC CONTEXT FOR HISTORICAL BUDGET DATA



A WORD OF CAUTION

Although this primer reports various rankings and metrics of performance throughout the document to provide readers with an idea of how Tennessee compares with other states, we provide a word of caution about these kinds of budget and spending metrics. Nearly every decision in the Budget about spending and taxing is associated with not only a direct outcome but an opportunity cost. Individual values and political perspectives will inform a person's understanding of how these trade-offs work. Take low taxes, for example. One direct outcome of low taxes is more dollars in the pockets of Tennesseans, but an associated opportunity cost is less spending on the state services and programs that help Tennessee taxpayers. This may mean that performing "well" on one narrow Budget-related measure may not be viewed in the same light by all stakeholders. Always keep in mind that Budget decisions represent trade-offs.

TENNESSEE'S BUDGET

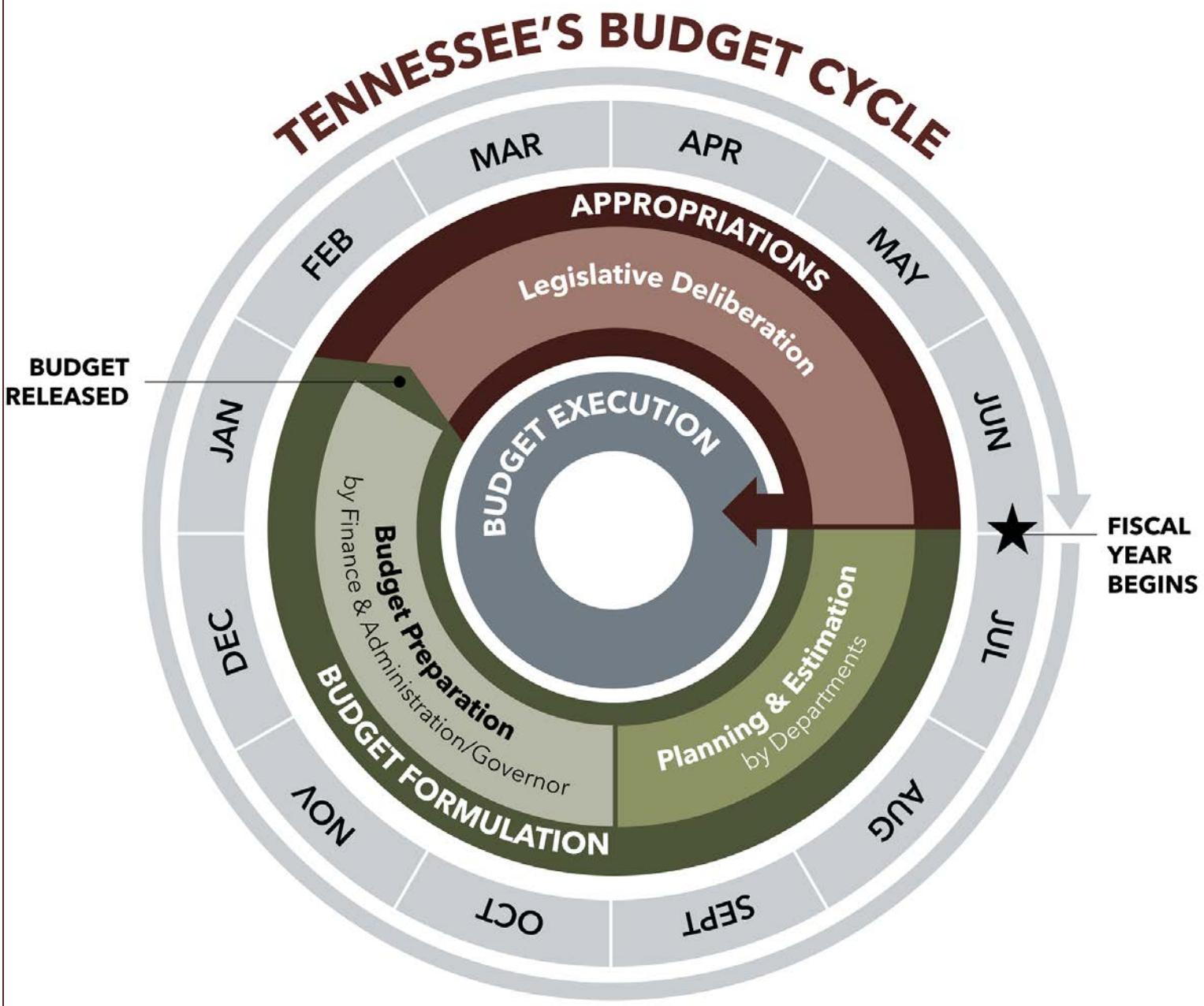


Sources: The Sycamore Institute's analysis of "Total State Budget: Comparison of Programs and Revenue Sources" and "Comparison Statement of State Revenues" from the FY 2016-2017 Tennessee State Budget.

The money flowing into the state government primarily comes from state taxes ($15.2 billion) and the federal government ($13.2 billion). Of state taxes, general sales tax dollars represent the largest share ($8.3 billion or 55% of state taxes). Other revenues include things like licenses and fees for specific services and privileges, tuition to state colleges and universities, and lottery ticket sales.

These revenues are spent overwhelmingly on health and social services ($15.8 billion) and education ($10.4 billion). Together these comprise 76% of the state's Budget. The rest of the Budget is dedicated to everything from supporting transportation and tourism to operating prisons and providing for public safety.

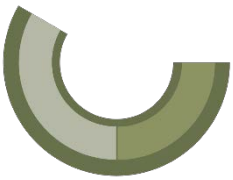
The Various Funds in the State Budget: Revenues are deposited in the state's various funds and then distributed to departments for expenditure. Some of Tennessee's dedicated funds include the General Fund, the Education Fund, and the Highway Fund. Each fund has specific state revenue sources that are established by the laws enacting various state tax streams. For example, about 60% of taxes on gas go to the state's Highway Fund (about 38% goes to cities and counties to support transportation). This approach provides some parameters for how much funding is available for each fund's purpose. Although each fund's purpose is fairly self-explanatory, General and Education Funds are nearly always spoken about together because revenues from the General Fund are always needed to fully fund appropriations for education. Together, these two funds comprise about 88% of the total Budget.



While Tennessee's fiscal year (FY) spans July 1st to June 30th, our state government is actually working on as many as *three* fiscal years at any given time. For example, we are currently in the midst of FY 2016-2017. At the same time, the Budget for next fiscal year is being formulated and considered. Although not shown in the figure above, work continues to close-out and audit the prior fiscal year into December each year.

Each year's taxing and spending levels are largely determined by the outcome of the budget formulation and appropriations processes carried out collaboratively by the executive branch and the state General Assembly. However, further changes always occur throughout the execution of the Budget. The state constitution's balanced budget requirement gives rise to the delicate dance that is the budget process and drives the dynamic nature of budget work.

THE BUDGET PROCESS



Budget Formulation: The state fiscal year (FY) begins on July 1st of each year and ends on June 30th of the next calendar year. FY 2016-2017, for example, began on July 1, 2016 and will end on June 30, 2017. Some also refer to this as FY 16-17 or FY 2017. The state fiscal year is different from the federal fiscal year, which begins on October 1st and ends on September 30th. The state budget process begins with the formulation of a budget recommendation from the executive branch (i.e. the Governor) to the legislative branch (i.e. the General Assembly).

Tennessee largely employs an incremental approach to budgeting, which means that much of the focus is on the incremental increases and decreases relative to the prior year. The starting point for a fiscal year's Budget is the prior fiscal year's recurring base budget. **The delineation between recurring and non-recurring is a tool that helps with longer-term budgeting under a balanced budget requirement**. Recurring expenses and revenues are expenses and revenues reasonably anticipated to occur year after year. To help ensure a balanced budget each year, new recurring expenses should be offset with either new or increased recurring revenues or a cut to an existing recurring expense. Non-recurring expenses are one-time expenses that are paid for with one-time revenues or one-time spending cuts. Items recommended as new non-recurring expenses and new recurring costs are often considered to be vulnerable in the budget process. It is worth noting that sometimes non-recurring expenses, despite their name, appear in the Budget year after year. In the Governor's most recent recommended Budget, about 92% – or $13 billion – of state revenue source spending was considered recurring while about 8% – or $1 billion – was non-recurring.[i]

Budget Formulation – *Planning and Estimation*: During the planning and estimation phase of the budget process, departments work largely on the spending side of the budget equation while the Department of Finance and Administration (F&A) is working on projecting tax revenues.

The development of the Budget begins almost a full year before the fiscal year begins. The process begins when the Department of F&A's Budget Division sends instructions to each of the state government's departments. These instructions ask departments to project their needs and wants for the upcoming fiscal year. Departments must provide information on the expenditures required to continue funding current services, to cover cost increases, to pay for mandated requirements, and to fund new initiatives and priorities. Departments are also often asked to identify opportunities for recurring savings. For FY 2017-2018, for example, departments were instructed to identify savings of at least 2%.[ii]

At the same time, the Budget Division begins the arduous task of estimating revenues. Thankfully, they have help. The Funding Board – made up of the Governor, the Commissioner of F&A, the Comptroller, the Secretary of State, and the Treasurer – receive, in recent years, separate revenue estimates from three different experts: the Legislature's Fiscal Review Committee, the executive branch's Department of Revenue, and the Boyd Center for Business and Economic Research (CBER) at the University of Tennessee. The Funding Board then uses these estimates to recommend to both the Governor and the Legislature an estimated range of how revenues are expected to grow or decline. The Budget's revenue estimates draw from this range. (See text box on page 10.)

ALL THE STEPS THAT GO INTO PRODUCING A BUDGET EACH AND EVERY YEAR AREN'T SIMPLY TRADITION. THEY ARE BASED IN LAW.

The state constitution, for example, gives the power of the purse to the state legislature by requiring that all public spending be appropriated (i.e. approved by the Legislature). Amendments to the constitution added in the 1970s also require a balanced budget under which state spending in any given fiscal year cannot exceed the state's collections and reserves. In other words, the money out can't be more than the money in.

Many of the steps involved in the budget process are laid out in state laws dating back to 1937. These laws, for example, not only require that the Governor submit a budget recommendation to the Legislature but also dictate what kinds of things must be included in the Budget and – to some extent – what steps must be taken to prepare the Budget.

Budget Formulation – *Budget Preparation*: Once departments have submitted their spending requests, the Budget Division, the Commissioner of F&A, and the Governor undertake the difficult job of not only making the math work but making it work with the politics. That is, they have to get the ins and the outs to balance while weighing department needs and priorities with the Governor's own policy goals.

This is largely accomplished through a bottom-up approach in which Budget staff first present budget overviews to the Commissioner of F&A and the Governor. The Governor conducts public hearings with department heads and will ultimately settle on a set of numbers to present to the Legislature.

These months of work culminate in the Budget document, which the Governor is required to deliver to the Legislature no later than February 1st each year, although it is usually delivered in late January in concert with the Governor's annual State of the State address. At the beginning of each four-year gubernatorial term, governors have until March 1st to submit the Budget.

Once the Budget is delivered, the Legislature begins its work. **Despite the hundreds of bills that the Tennessee General Assembly passes every year, the budget bill – or appropriations bill – is technically the only bill that it *must* pass. Without it, much of the state government legally cannot operate, because it cannot legally spend the revenue that it receives.**

Appropriations – *Legislative Deliberation*: The legislative process begins with a draft of the appropriations bill. The Department of F&A translates the Budget into legislative language that is introduced in both the House of Representatives and the Senate as the appropriations bill. This is the Legislature's starting point. Both the House and Senate have Finance, Ways & Means Committees (or Finance Committees), whose primary job is working on the Budget. They hold hearings on the recommended Budget and consider and make incremental changes to the appropriations bill through amendments. The Governor's Budget is largely oriented towards incremental changes to the prior year's recurring base budget. Because the appropriations bill begins its life as a reflection of the Governor's Budget, the legislative appropriations process and final bill represent incremental changes to the recommended Budget. In fact, the amendments added to the appropriations bill throughout the legislative process call out specific increases or cuts to the Governor's recommendation. (See page 14.)

Throughout the process, the General Assembly must do its own balancing act – the chore of weighing the Governor's priorities outlined in the Budget with legislators' own initiatives and priorities, including finding ways to pay for new legislation, all while making the math work. **Ultimately, every dollar spent – including federal ones – must be appropriated.**

Although this step of the process is the legislative one, the Governor and the Department of F&A remain highly involved. For example, they provide updated estimates, in concert with the General Assembly's Office of Legislative Budget Analysis, to ensure that the appropriations bill remains balanced as amendments are adopted and revenue projections change.

Other committees may also hold their own hearings on the parts of the Budget under their jurisdiction, but it is ultimately the responsibility of the Finance Committees to report an appropriations bill to the Senate and House.

Bills passed by the Finance Committees must be passed by both the full House and Senate chambers. As with all laws, an identical bill must ultimately pass both chambers. Once passed, it goes to the Governor's desk. The state constitution gives the Governor the power to veto the entire bill or strike or change individual line items in the bill (i.e. a line-item veto). The use of either power is rare. If put to use, however, the Legislature can overturn it with a simple majority vote.

In addition to the appropriations bill, the Legislature may also have to consider and pass other measures to get the numbers to work. For example, the Legislature may want to make changes to the tax code that would impact revenues or to eligibility requirements for a program that would impact expenditures. According to restrictions in state law, these kinds of changes to so-called "general law" (i.e. existing laws outside of appropriations) cannot be included in an appropriations bill and must be considered and passed separately.

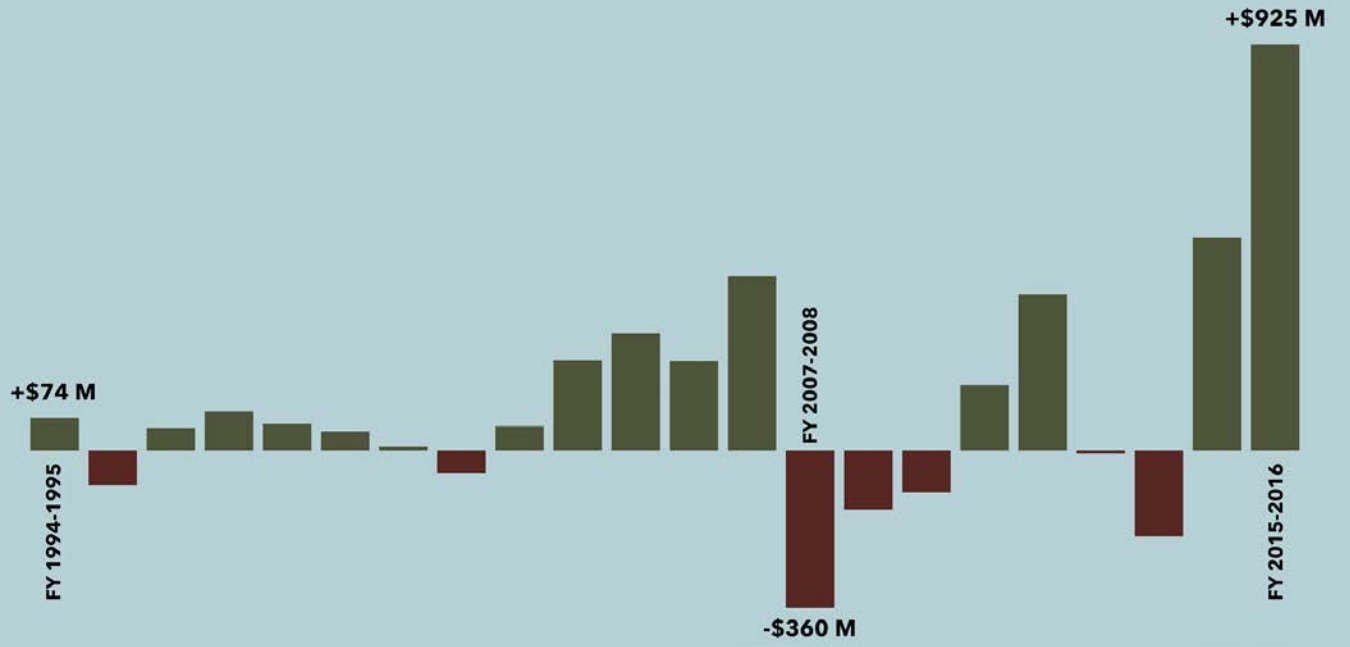
HOW ARE WE DOING?

REVENUE ESTIMATION[2]

Under a balanced budget, decisions about overall spending levels – and, by extension, spending on specific programs and services – are based primarily on revenue forecasts. Not surprisingly, forecasting revenue collections is hard. Overestimating revenues could force policymakers to cut spending mid-year. While underestimating revenues can allow savings to be stowed away for a rainy day, *consistently* underestimating them could mean policymakers needlessly forgo spending on programs and services or reducing taxes.

The figure below displays how accurate Tennessee has been at estimating its tax collections. When positive, the state collected more than it expected (i.e. underestimated). When negative, collections were less than expected (i.e. overestimated). Not surprisingly, there were a couple of pretty large overestimations in the midst of the Great Recession. The forecasts on which final appropriations decisions were made by the Legislature were used for FYs 2014-2015 and 2015-2016. These forecasts were not publicly available for the other years, so actual collections are compared with estimates made in the midst of the particular fiscal year. As a result, this display likely understates the inaccuracy of the forecasts on which the Budget was based for these years.

ACTUAL vs. ESTIMATED/BUDGETED STATE TAX COLLECTIONS



Sources: The Sycamore Institute's analysis of "Comparison Statement of State Revenues" from the FY 1994-1995 – FY 2016-2017 Tennessee State Budgets and the July 2015 and July 2016 Tennessee Department of Finance & Administration Monthly Revenue Reports.

The biggest piece of the state tax pie is the general sales tax (see page 22). In terms of volatility, which refers to annual fluctuations in revenue collections, sales taxes are considered the least volatile of major state tax revenue sources (i.e. sales taxes, income taxes, and corporate taxes). With less volatility, sales taxes are also the most predictable. Both individual incomes – particularly high ones – and corporate profits tend to rise and fall dramatically with overall economic conditions. Over the last two decades, both have become more closely linked with the stock market, which is even more volatile than the overall economy. This makes them more unpredictable than sales taxes. Sales taxes are, of course, also impacted by economic conditions, but less than these other state revenue sources. Consumption of the goods that make up the base of sales tax revenues – particularly staples like groceries – tends to vary less than corporate profits do. Because of the state's reliance on sales taxes, Tennessee's state tax structure is considered to be one of the least volatile in the country.

The Department of Finance and Administration releases revenue collections reports monthly, which allow both the state and the public to see how actual revenues are stacking up against the projections on which the Budget was based. Those reports are available on the Department of Finance and Administration's website.

See page 40 for a full list of sources.

Other legislation passed by the General Assembly may also have a fiscal impact – further complicating the decisions that have to be made in the appropriations bill. The General Assembly's Fiscal Review Committee estimates the cost or savings associated with each and every bill introduced in what is called a "fiscal note." Fiscal notes are created using a set of assumptions published in the note itself and feedback from impacted state departments and agencies and others who may have relevant data or information. They often do not reflect ancillary impacts – like the effect that investments in prevention may have on long-term health care costs or that tax code changes may have on the broader economy. These types of "dynamic scoring" practices can be notoriously difficult to quantify and, as a result, cannot serve as a basis for deciding how to balance the budget. **The appropriations bill must fund the estimated first year's cost of any new legislation, or the legislation is automatically voided.** In many cases, appropriations bills will include funding for specific bills that have passed. Many years' appropriations bills – including the most recent one – have a provision known as the "sweeper clause" that funds any enacted legislation with a cost of less than $50,000, as estimated by the fiscal note.

Final appropriations are usually passed and signed by the Governor in the last week of the legislative session, which has recently been in April. **In the rare event that the Legislature is unable to complete its job by June 30th, the state would be unable to spend most of the money it collects until an appropriations bill gets passed and signed**. Only twice in modern history has the Legislature passed temporary, short-term appropriations bills in order to continue state operations while Budget issues were resolved after June 30th.

Budget Execution: Once appropriations have been enacted and the fiscal year begins on July 1st, the administration begins executing the Budget. The resulting budget plan is known as the "work program." Departments and programs are able to begin spending money through allotments issued by F&A that are consistent with the amounts appropriated by the Legislature.

In the course of the fiscal year, the Budget must be actively managed to fulfill balanced budget requirements and meet program needs – including responding to changed circumstances or economic downturns or addressing unintended estimation errors. Only the General Assembly can appropriate funds, but there are a number of reasons that appropriations might be adjusted after the beginning of a fiscal year or that spending may ultimately differ from appropriations.

First, with the next annual Budget document, the Governor often recommends **supplemental appropriations** that increase current year appropriations. These supplemental requests are enacted with the next year's appropriations bill in the midst of the affected fiscal year.

Second, the appropriations bill includes so-called **sum-sufficient appropriations** for some programs. These provide undefined appropriations for departments to spend collected or reserved funds, usually from dedicated taxes or fees that are available only to specific programs. These sum-sufficient appropriations may be made available with the approval of the Commissioner of F&A, which may alter a program or department's overall budget from the amounts explicitly cited in the Budget document or the appropriations act.

OPPORTUNITIES FOR ENGAGEMENT

Public hearings are held throughout the process on both the Budget and revenue projections.

In recent years, governors have held public hearings on the upcoming fiscal year's Budget for each department in November and early December. These are usually announced in mid-November on the Governor's website and are recorded and available for viewing both live and after on the state's website. These hearings last about an hour and include presentations by department leadership followed by a question and answer session by the Governor, the state's Chief Operating Officer, the Commissioner of Finance and Administration, and the Budget Division Director.

The State Funding Board holds public meetings to discuss revenue projections. These are announced on the Comptroller's website and are usually in November or December.

The House Finance Committee and Senate standing committees, including the Finance Committee, also hold public hearings on the recommended Budget – generally in February and March. These presentations are announced with the Committees' weekly calendars posted on the House calendar webpage and the Senate calendar webpage. These hearings usually include a presentation from administration officials followed by a question and answer session by the Committee members.

Third, the appropriations bill makes available all the **federal and other departmental revenues** that programs may earn. Additional federal or departmental revenues above those explicitly appropriated may become available to a

department in the midst of a fiscal year – for example, an unanticipated federal grant. To spend these funds, the affected department must receive approval from the Commissioner of F&A, who, if he/she approves, must submit a program expansion report to the Senate and House Finance Committees and receive the Committee chairs' written acknowledgment before allotting the funds. If the Legislature is in session when the program expansion report is submitted, then the chairs must hold a committee hearing before signing the acknowledgment. This method cannot be used to increase appropriations from state taxes but may change a program or department's overall budget in the course of a fiscal year.

Fourth, all authorized state employee positions are fully funded in the Budget and the appropriations bill but are rarely all filled all the time. While these amounts are allotted to departments and available for expenditure, most state agencies naturally spend less than the appropriation because of this budget practice. Program managers have the flexibility to fill positions as needed, but because programs almost always have some vacancies during the year, payroll savings occur. Additional program underspending will often occur for other reasons as well. Rather than discounting appropriations at the department or program level to account for this underspending, these savings are aggregated and estimated at the bottom-line of the state Budget. This allows program directors to manage their programs as circumstances require without having to restrict activities to satisfy a budgeted amount of underspending. This bottom-line savings is called the **over-appropriation**, which in recent years has totaled about $80 million on a recurring basis. This is another reason that actual spending is often different than the appropriation.

Finally, in economic downturns or recessions, state revenues are likely to be less than budgeted estimates, so the General Assembly provides a considerable amount of flexibility to the Governor and Commissioner of F&A to manage the Budget within available resources. In these circumstances, the Commissioner will often freeze vacant positions (not allow them to be filled), restrict out-of-state travel by state employees, limit equipment purchases by state agencies, and require other temporary program reductions to increase program **underspending**. Because these types of actions are one-time or time-limited, they create additional, one-time savings to make it through short-term downturns.

In the new Budget document presented to the Legislature at mid-year or in a later amendment to the appropriations bill, the Administration will re-estimate the bottom-line over-appropriation to account for the additional underspending associated with these actions. The additional one-time savings are considered non-recurring over-appropriations and are added to the $80 million recurring over-appropriation. This increased estimate of underspending will help balance the Budget at year-end on a non-recurring basis. If a downturn and recovery span multiple years, new savings – either recurring or non-recurring – must be found to balance the succeeding Budget. In a recession as deep as the Great Recession of 2007-2009, the Budget was balanced each year with both recurring and non-recurring reductions, non-recurring reserves, and non-recurring federal aid. It took several years to balance the Budget on a recurring basis, in which recurring expenditures were fully funded by recurring revenue collections.

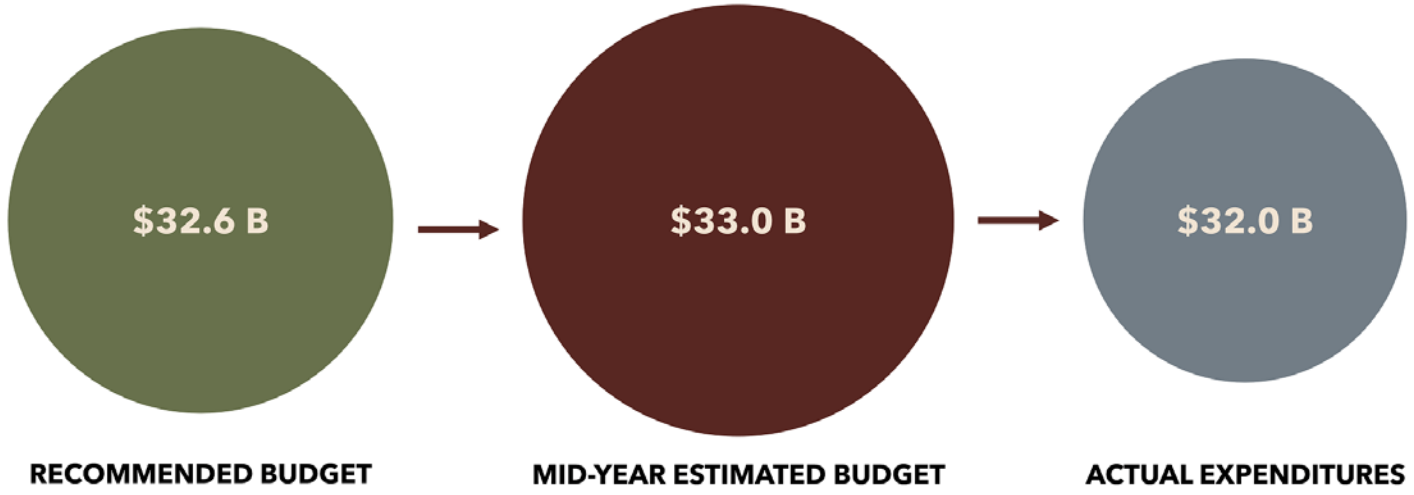
It is important to bear in mind that, just as the Governor cannot appropriate funds (only the General Assembly can), the Governor cannot eliminate programs established by law in order to generate savings without legislative approval through law. Nevertheless, in law and in practice, **there is considerable precedent for strong Executive management to keep the Budget in balance after a fiscal year begins**, and the General Assembly has provided the Governor and the Commissioner of F&A the means to maintain balance.

These execution eccentricities of underspending and over-appropriation mean that actual expenditures can be significantly different than the enacted appropriation.

This also means that comparisons between "budget" numbers and "actual" numbers are misleading. The "actual" column in the Budget represents what was in fact spent by the government and its many departments (i.e. expenditures). The "estimated" and "recommended" columns associated with the current and upcoming fiscal years, respectively, however, are budget numbers that include the over-appropriation and do not account for any underspending. **This makes the current and upcoming fiscal year spending amounts look higher than the actual expenditure amounts even when they don't necessarily represent real spending increases.**

The figure below shows how the Budget and spending changed throughout the Budget process for FY 2014-2015. The General Assembly often passes a Budget that is bigger than what was recommended by the Governor, and actual spending is usually smaller.

FY 2014-2015



Sources: "Total State Budget: Comparison of Programs and Revenue Sources" from the FY 2014-2015, FY 2015-2016, and FY 2016-2017 Tennessee State Budgets.

HOW ARE WE DOING?

CONSENSUS BEST PRACTICES IN BUDGET PROCESSES[3]

States that employ best practices in budgeting adhere to the following widely-accepted principles:

- The budget development process should be informed by clear goal-setting and established policies on items like rainy day funds, the use of recurring and non-recurring revenues, and debt.
- The budget process should be clear and consistent – with an established timeline, instructions, and processes.
- The budget process should involve long-term planning – including multi-year forecasting of both spending needs and revenue collections.
- Revenue estimation should be done using a consensus approach that includes input from the legislative and executive branches.
- Budget documents should include a "current services baseline" that estimates the cost associated with continuing all the government's services – including considerations of things like cost increases and population/eligibility growth.
- Budgets should be informed by performance monitoring and program evaluations.
- Legislatures should employ a nonpartisan fiscal office to analyze both the budget and legislation.
- Legislation should be accompanied by publicly-available fiscal notes that estimate multi-year impacts on the state budget.

See page 40 for a full list of sources.

KEY BUDGET DOCUMENTS

THE BUDGET is the Governor's recommendation to the General Assembly for the upcoming fiscal year. Throughout this primer, it is referred to interchangeably as the Budget document, the recommended Budget, and the Governor's Budget. In recent years, the Budget has included three separate documents:

- ***The Budget*** includes most of the information and numbers of interest. This document not only slices and dices topline numbers in nearly every way imaginable (e.g. by revenue source, by expenditure category, by department), it also includes program-specific funding information.
- ***Volume 2: Base Budget Reductions*** shows recommended funding reductions at various levels of detail.
- ***Recommended Budget: Expenditures by Object and Funding by Source*** provides an extremely detailed accounting of the Budget dollars by "object." Objects are categorizations that help the state keep track of spending on specific types of activities like salaries, travel, supplies, grants, and employment levels in each agency.

All three documents are available for viewing and download on the Department of Finance and Administration's website.

KEY BUDGET DOCUMENT ITEMS

A few can't-miss items in "The Budget" volume (with FY 2016-2017 Budget page numbers) include:

The **BUDGET HIGHLIGHTS** (pages xix-xxviii) section includes a discussion of the overall Budget, its themes (e.g. "Plan for Balancing" on page xix), and issue-specific strategies (e.g. "Safe Communities" on page xxiv).

The **TOTAL STATE BUDGET - COMPARISON OF PROGRAMS AND REVENUE SOURCES** table (page A-8) shows the overall Budget with very high level information on the programs across which spending is distributed and the sources from which revenue comes.

The **COMPARISON OF PROGRAMS** table (page A-17 – A-22) shows total funding levels for each department by revenue category.

The **COMPARISON STATEMENT OF STATE REVENUES** table (page A-64) displays actual and estimated collections for specific state taxes.

The **PROGRAM STATEMENT BY FUNCTIONAL AREA** (beginning on page B-3) provides additional Budget information at a more granular activity level. These pages display total funding by revenue source for activities within departments and include brief explanations for recommended funding increases. This information is organized by "functional area," which represent related activities like health and social services.

THE ADMINISTRATION AMENDMENT includes changes to the Budget submitted by the Governor prior to the enactment of appropriations. The Amendment summaries are made available online on the Department of Finance and Administration's website.

THE APPROPRIATIONS BILL is passed by the state Legislature and enacts the Budget. It begins as a reflection of the Governor's Budget and is amended throughout the legislative process to incorporate changes from both the Administration and the Legislature. Section 1 includes the appropriation of state funding by department and program while Section 4 appropriates other revenue sources. Subsequent sections earmark funds within each department's appropriation for specific purposes and/or incorporate amendments that may increase or reduce the appropriation. The most recent appropriations bill can be found on the General Assembly's website or the Secretary of State's website.

> Example of an Appropriations Bill Earmark: *Section 7, Item 33 (p39 of 2016 Public Chapter 758) – Department of Mental Health and Substance Abuse Services, Community Mental Health Services, in Section 1, Title 111-14, Item 2.5, an amount of $400,000 is to be paid to Centerstone Military Services, in three regions of Tennessee for the purpose of providing professional counseling services to veterans and their families who suffer from post-traumatic stress disorder (PTSD).*

Example of an Appropriations Bill Increase Amendment: *Section 66, Item 46 (p99 of 2016 Public Chapter 758) – In addition to any other funds appropriated by the provisions of this act, there is appropriated the sum of $750,000 (non-recurring) to the Department of Health for the sole purpose of making a grant in such amount to the Smile 180 Foundation, to be used for programs and services across the state.*

Example of an Appropriations Bill Reduction Amendment*: Section 64, Item 4 (p94 of 2016 Public Chapter 758) – The appropriation to the Department of Health in Section 1, Title 111-16, Item 4, is reduced by the sum of $2,000,000 (non-recurring). Such funding reduction is for the purpose of reducing funding for the Governor's Health and Wellness Foundation.*

FISCAL NOTES are created by the staff of the Legislature's Fiscal Review Committee, a joint oversight committee that includes a total of 15 members from both the House and Senate and is supported by a nonpartisan staff of 14. Fiscal notes estimate the cost or savings associated with all the legislation introduced in a session. Fiscal memos estimate the impact of amendments to legislation. If an error is discovered, the fiscal notes/memos are re-issued as corrected fiscal notes and memos. Fiscal notes are posted alongside their respective legislation on the General Assembly's website.

After the end of each legislative session, the Fiscal Review Committee presents a cumulative fiscal note that rolls up the net impact of all legislation passed and funded during the session on revenues and expenditures. This impact is broken down by changes to recurring and non-recurring revenues and expenditures and delineates between what impacts were and were not included in the Governor's Budget.

THE SESSION SUMMARY is created by the Office of Legislative Budget Analysis and summarizes the enacted appropriations. It also includes selective information on "noted" legislation for which the appropriations bill includes funding and amendments to the appropriations bill. These summaries are usually posted on the General Assembly's website in August.

THE STATE FACT BOOK provides high level funding information by department that reflects a mid-year estimate of the Budget and is available for download on the General Assembly's website. It is usually published in November.

MONTHLY REVENUE REPORTS provide monthly updates on the Department of Revenue's collections. They show how well actual collections are stacking up against the estimates on which the Budget was based and against collections of the previous year. These are made available each month on the Department of Finance and Administration's website.

KEY PLAYERS IN THE BUDGET PROCESS

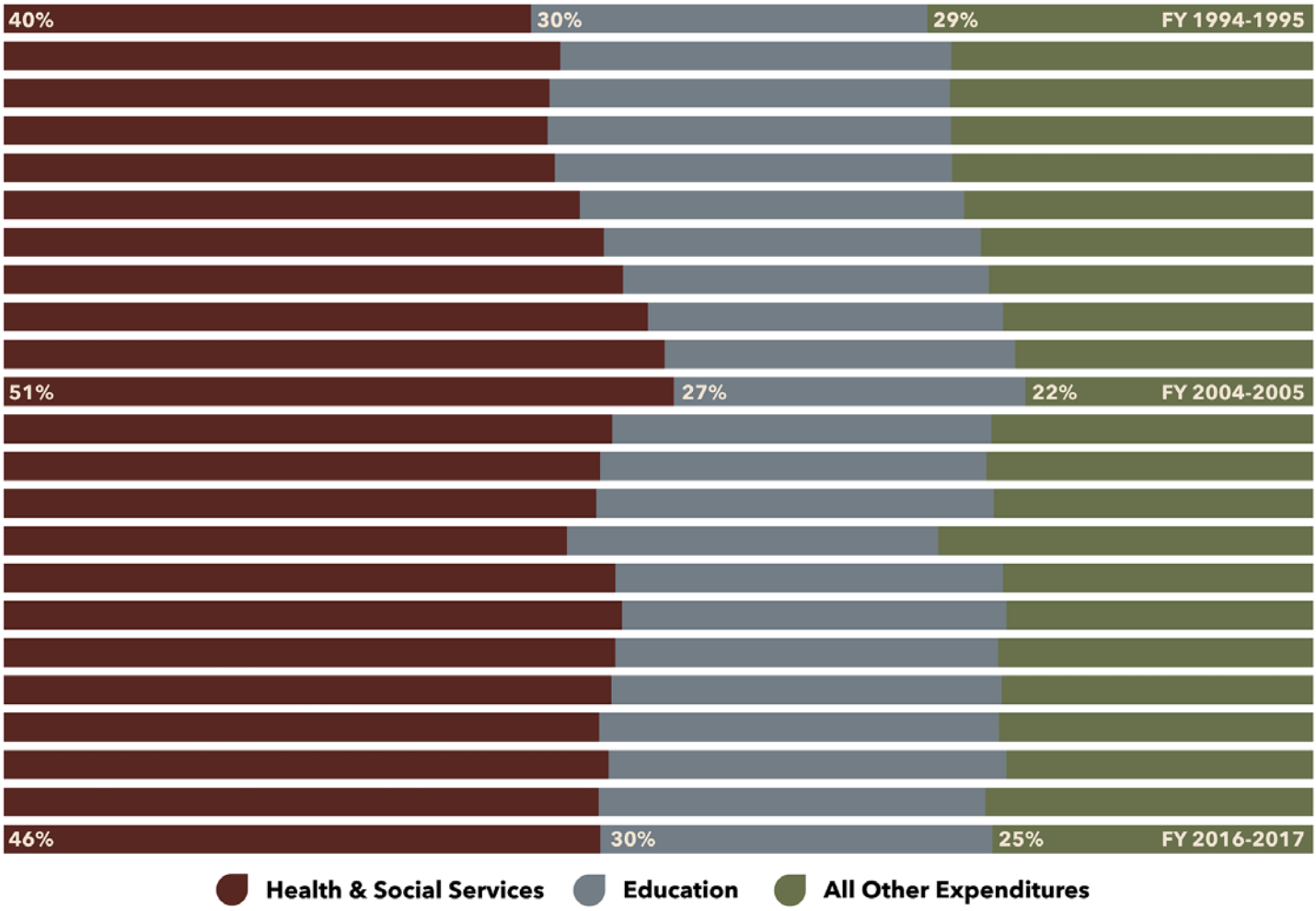
Governor
Governor's Senior Staff
Commissioner and Deputy Commissioner of Finance and Administration
Department of Finance and Administration's Budget Division
Department of Revenue
Commissioners & Directors of other state departments and agencies
The State Funding Board
Treasurer
Comptroller of the Treasury
Secretary of State
Tennessee General Assembly
House Finance, Ways and Means Committees
Senate Finance, Ways and Means Committee
Fiscal Review Committee
Office of Legislative Budget Analysis
UT Boyd Center for Business & Economic Research

THE COMPREHENSIVE ANNUAL FINANCIAL REPORT (CAFR) is published after a fiscal year has ended and is an accounting of the state's actual financial activities. Due to accounting standards, the CAFR reports information in a format that is different than the Budget document. CAFRs are available for viewing on the Department of Finance and Administration's website.

HISTORICAL BUDGET TRENDS:

EXPENDITURES

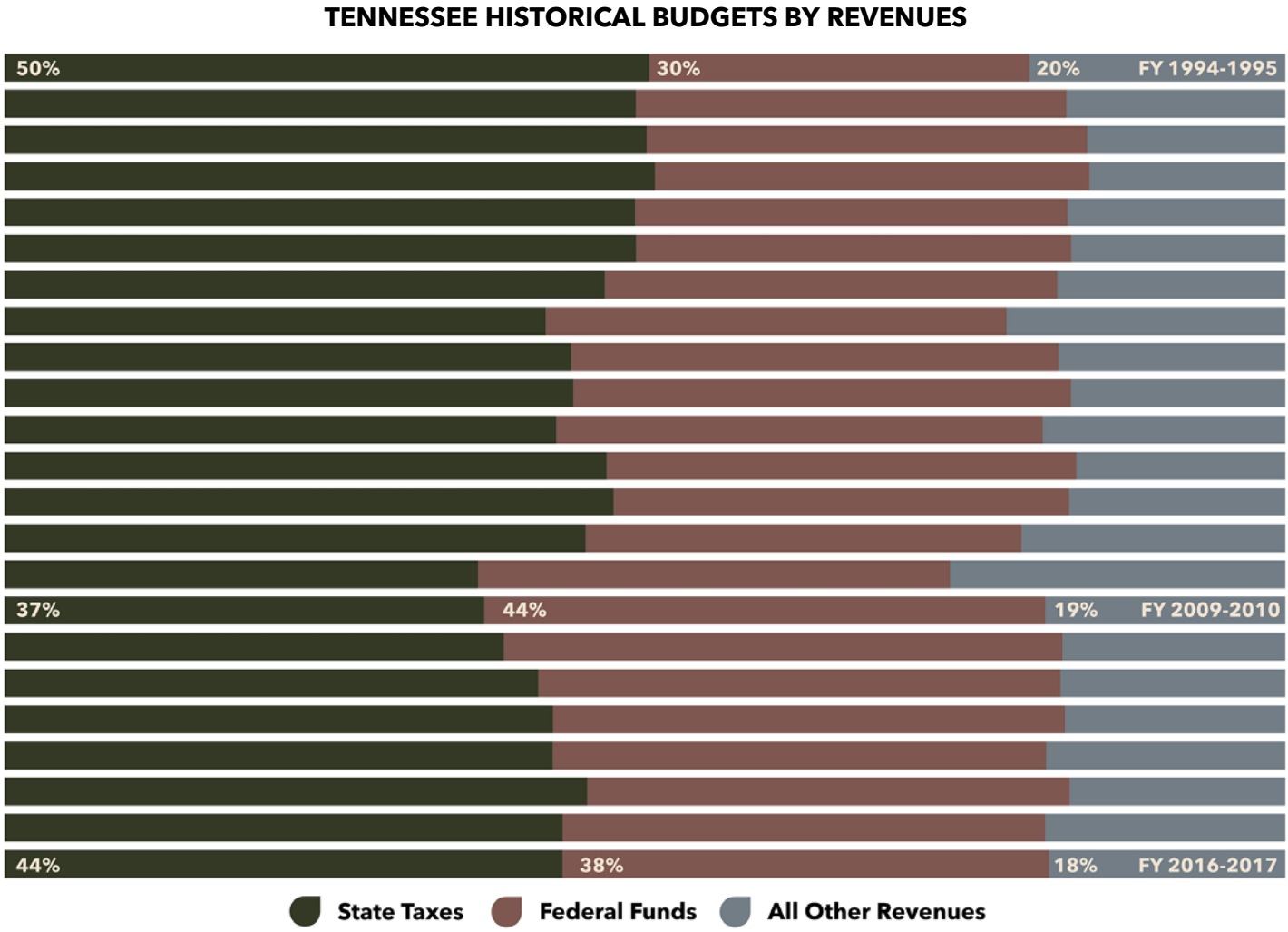
TENNESSEE HISTORICAL BUDGETS BY EXPENDITURE



Sources: The Sycamore Institute's analysis of "Comparisons of Programs" from the FY 1996-1997 – FY 2016-2017 Tennessee State Budgets.
Note: Includes all funding sources. Numbers may not total 100% due to rounding.

Over the last two decades, the Budget's mix of services has seen its ups and downs. For example, when TennCare launched in 1994, health and social services comprised 40% of the state's Budget while education and all other expenditures comprised about 30% each. By FY 2004-2005, health and social services peaked at 51%, while education had fallen to 27%, and everything else to 22%. Today, we find ourselves somewhere in the middle.

HISTORICAL BUDGET TRENDS:
REVENUES

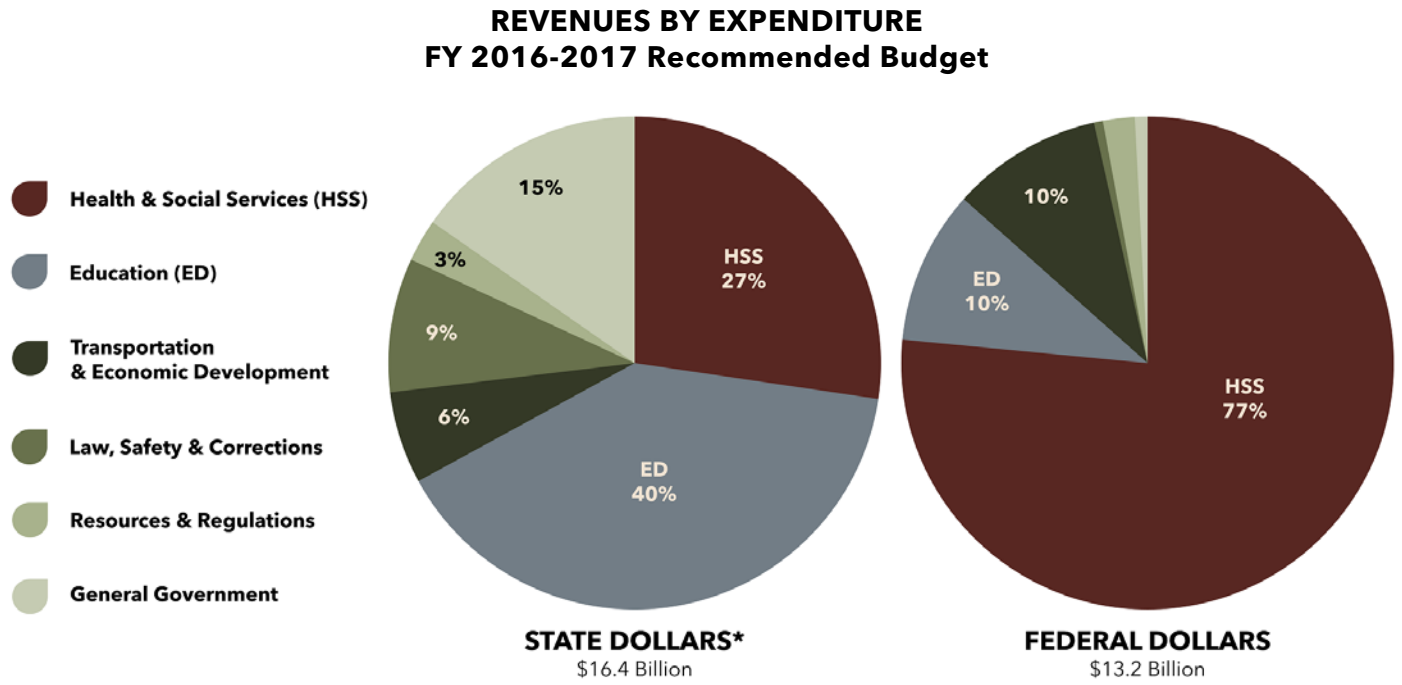


Sources: The Sycamore Institute's analysis of "Total State Budget: Comparison of Programs and Revenue Sources" and "Comparison Statement of State Revenues" from the FY 1996-1997 – FY 2016-2017 Tennessee State Budgets.

Just as the state's mix of spending has changed, so too has the mix of revenues. Over the last two decades, the state's own tax revenues peaked at 50% of the state's Budget in both FYs 1994-1995 and 1996-1997. As a response to the Great Recession in 2009, the U.S. Congress made additional federal dollars available to states via the American Recovery and Reinvestment Act (ARRA). As a result, federal dollars accounted for 44% of the state's Budget in FYs 2009-2010 and 2010-2011, the highest proportion over the last two decades. (See page 30.)

DIGGING DEEPER:

REVENUES & EXPENDITURES

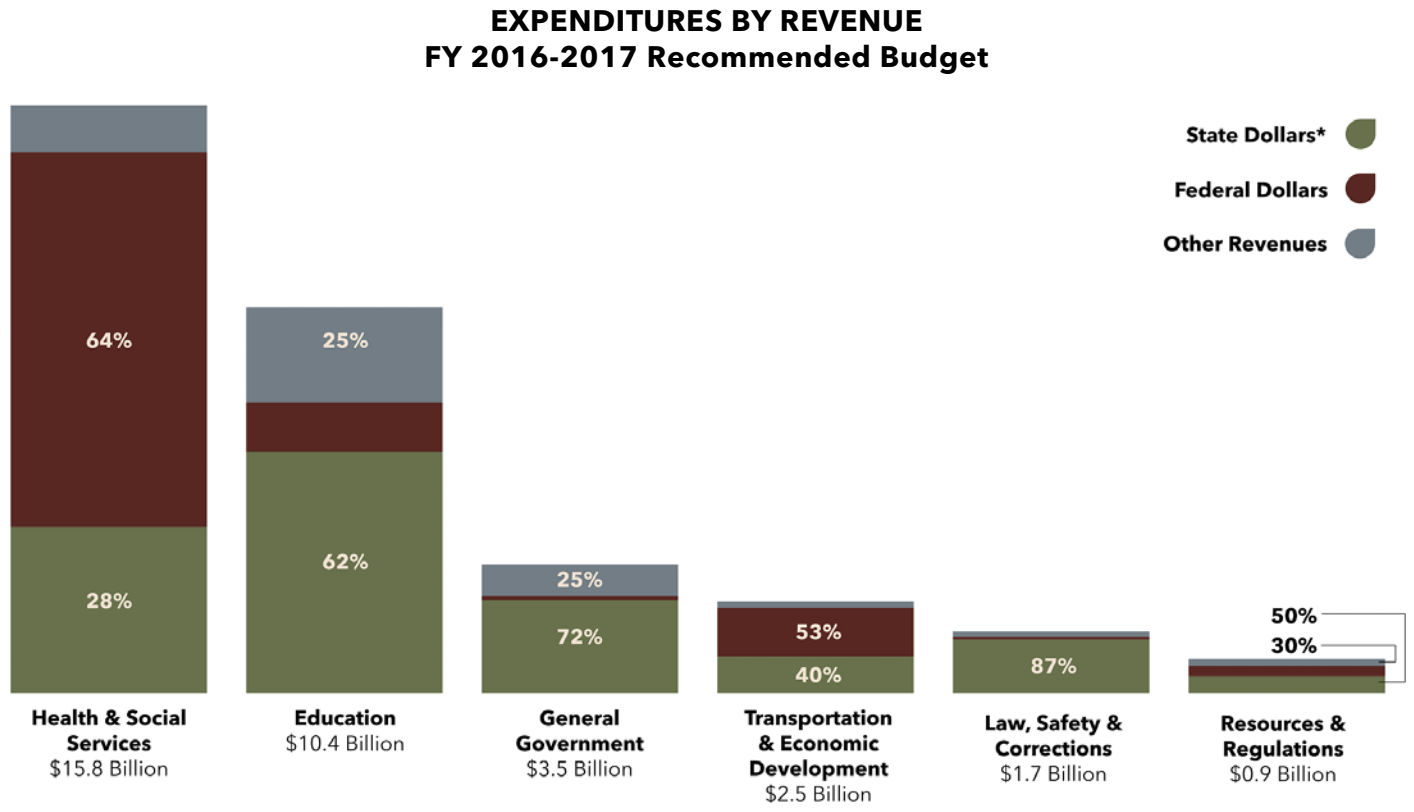


Source: The Sycamore Institute's analysis of "Comparison of Programs" from the FY 2016-2017 Tennessee State Budget.
** The state dollar classification is more inclusive than the state tax classification used on page 6. The General Government category includes Miscellaneous Appropriations, Capital Outlays, and state taxes shared with cities and counties. This differs from the same metric displayed on page A-6 of the FY 2016-2017 Budget. Please see the methodology notes online for additional information.*

All the dollars flowing into the state are not divvied up to the state's various programs and services in the same way. For example, 46% of the overall Budget is dedicated to health and social services (see page 6), but these kinds of programs receive more support from the federal government than other programs funded by the state. As a result, 77% of the federal funding that the state receives is spent on health and social services while only 27% of the state's own dollars are spent on them. Because the state has relatively little say over the federal dollars coming in (more on this topic beginning on page 29), this provides a clearer picture of how the state's own dollars are spent.

DIGGING DEEPER:

REVENUES & EXPENDITURES



Source: The Sycamore Institute's analysis of "Comparison of Programs" from the FY 2016-2017 Tennessee State Budget.
** The state dollar classification is more inclusive than the state tax classification used on page 6. The General Government category includes Miscellaneous Appropriations, Capital Outlays, and state taxes shared with cities and counties. This differs from the same metric displayed on page A-6 of the FY 2016-2017 Budget. Please see the methodology notes online for additional information.*

Just as all the dollars flowing into the state are not divvied up to the state's various programs and services in the same way, not all programs are funded with the same mix of revenue sources. For example, while the largest source of revenue for the state Budget is the state's own taxes (see page 6), health and social services and transportation and economic development programs and activities are predominantly funded with federal dollars. Different requirements may be associated with different funding streams (see page 29). This means that the mechanisms for programmatic and spending changes for different programs may vary depending on the revenue types with which they are funded.

DIGGING DEEPER:

EXPENDITURES BY DEPARTMENT

EXPENDITURES BY DEPARTMENT
FY 2016-2017 Recommended Budget

DEPARTMENT / AGENCY	TOTAL (in millions)	% of TOTAL BUDGET	DEPT/AGENCY FUNDING COMPOSITION			CATEGORY
			STATE	FED	OTHER	
Bureau of TennCare (Dept of F&A)	$10,852	31.2%	33%	63%	5%	HSS
Dept of Education (K-12)	$6,003	17.3%	79%	19%	2%	ED
Higher Education	$4,410	12.7%	40%	5%	56%	ED
Dept of Human Services	$2,841	8.2%	6%	91%	3%	HSS
Dept of Transportation	$1,878	5.4%	40%	53%	6%	TRANS
State Shared Taxes with Cities & Counties	$1,026	3.0%	100%	0%	0%	GG
Dept of Correction	$962	2.8%	98%	0%	2%	LAW
Dept of Children's Services	$754	2.2%	39%	21%	39%	HSS
Dept of Health	$609	1.8%	32%	41%	27%	HSS
Capital Outlay Program	$429	1.2%	83%	3%	14%	GG
Debt Service Requirements	$425	1.2%	100%	0%	0%	GG
Dept of Environment & Conservation	$387	1.1%	47%	23%	30%	REG
Dept of Finance & Administration	$329	0.9%	8%	17%	75%	GG
Dept of Mental Health & Substance Abuse	$325	0.9%	67%	19%	14%	HSS
Facilities Revolving Fund	$296	0.9%	45%	0%	55%	GG
Tennessee Housing Development Agency	$293	0.8%	0%	93%	7%	TRANS
Strategic Healthcare Programs (Dept of F&A)	$260	0.7%	6%	94%	1%	HSS
Miscellaneous Appropriations	$224	0.6%	100%	0%	0%	GG
Dept of Commerce & Insurance	$213	0.6%	73%	0%	27%	REG
Dept of Labor & Workforce Development	$210	0.6%	21%	77%	2%	REG
Dept of Safety	$200	0.6%	70%	5%	25%	LAW
Dept of Economic & Community Development	$176	0.5%	83%	15%	2%	TRANS
Dept of Intellectual & Developmental Disabilities	$158	0.5%	15%	0%	85%	HSS
Court System	$137	0.4%	95%	1%	4%	LAW
Dept of Revenue	$127	0.4%	75%	0%	25%	GG
Dept of General Services	$123	0.4%	8%	0%	92%	GG
District Attorney Generals Conference	$117	0.3%	71%	0%	29%	LAW
Claims & Compensation	$116	0.3%	10%	4%	86%	GG
Comptroller of the Treasury	$103	0.3%	91%	0%	9%	GG
Dept of Agriculture	$97	0.3%	71%	13%	16%	TRANS
Wildlife Resource Agency	$91	0.3%	61%	28%	11%	REG
Tennessee Bureau of Investigation	$72	0.2%	57%	21%	22%	LAW
Secretary of State	$71	0.2%	41%	42%	17%	GG
Military Department	$69	0.2%	21%	75%	4%	LAW
TN Rehabilitative Initiative in Correction (TRICOR)	$55	0.2%	0%	0%	100%	LAW
District Public Defenders Conference	$52	0.1%	99%	0%	1%	LAW

CATEGORIES: Health & Social Services (HSS), Education (ED), General Government (GG), Transportation & Economic Development (TRANS), Law, Safety & Corrections (LAW), Resources & Regulations (REG)

EXPENDITURES BY DEPARTMENT
FY 2016-2017 Recommended Budget
(continued)

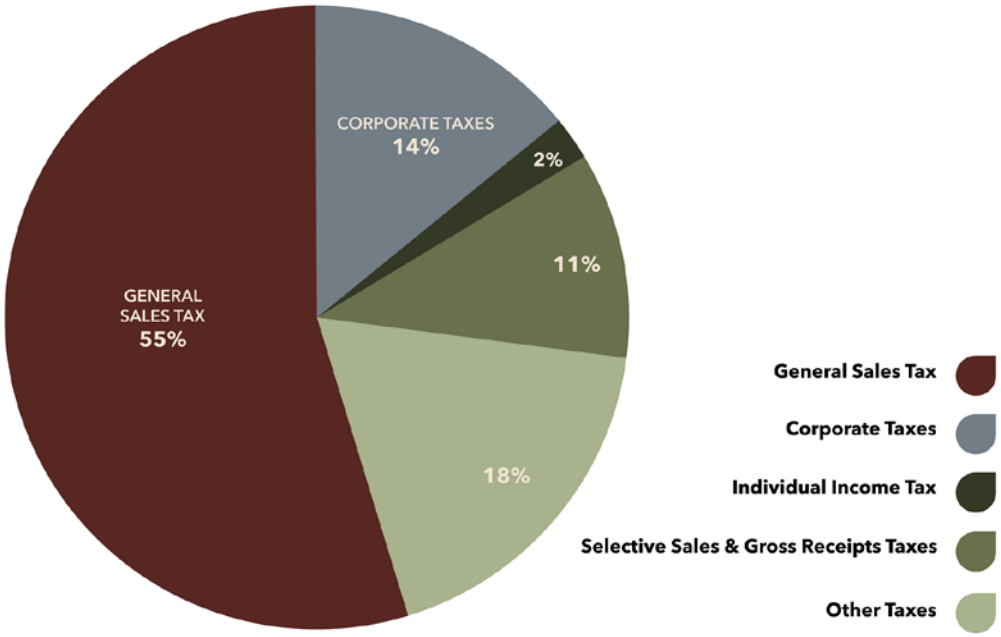
DEPARTMENT / AGENCY	TOTAL (in millions)	% of TOTAL BUDGET	DEPT/AGENCY FUNDING COMPOSITION			CATEGORY
			STATE	FED	OTHER	
Legislature	$42	0.1%	100%	0%	0%	GG
Commission on Aging & Disability	$42	0.1%	33%	67%	0%	HSS
Treasury Dept	$41	0.1%	8%	0%	92%	GG
Attorney General & Reporter	$40	0.1%	69%	0%	31%	LAW
Dept of Tourist Development	$29	0.1%	68%	0%	32%	TRANS
Dept of Financial Institutions	$20	0.1%	100%	0%	0%	REG
Dept of Human Resources	$13	0.0%	0%	0%	100%	GG
Tennessee Regulatory Authority	$9	0.0%	73%	10%	16%	GG
Alcoholic Beverage Commission	$8	0.0%	0%	0%	100%	LAW
Arts Commission	$8	0.0%	82%	11%	7%	REG
Board of Parole	$7	0.0%	100%	0%	0%	LAW
Veterans Services	$7	0.0%	81%	15%	4%	GG
Executive Department	$5	0.0%	100%	0%	0%	GG
TN Commission on Children & Youth	$4	0.0%	56%	28%	16%	HSS
State Museum	$4	0.0%	100%	0%	0%	REG
TN Advisory Commission on Intergov'tal Relations	$3	0.0%	7%	0%	93%	GG
TN Human Rights Commission	$2	0.0%	69%	31%	0%	GG
Office of Post Conviction Defender	$2	0.0%	100%	0%	0%	LAW
Council on Developmental Disabilities	$2	0.0%	11%	87%	2%	HSS
Fiscal Review Committee	$1	0.0%	100%	0%	0%	GG
Health Services & Development Agency	$1	0.0%	100%	0%	0%	HSS
Emergency & Contingency Fund	$1	0.0%	100%	0%	0%	GG
State Building Commission	$0	0.0%	63%	0%	38%	GG

CATEGORIES: Health & Social Services (HSS), Education (ED), General Government (GG), Transportation & Economic Development (TRANS), Law, Safety & Corrections (LAW), Resources & Regulations (REG)

Source: The Sycamore Institute's analysis of "Comparison of Programs" table from the FY 2016-2017 Tennessee State Budget.

DIGGING DEEPER:

STATE TAXES



Source: The Sycamore Institute's analysis of "Comparison Statement of State Revenues" from the FY 2016-2017 Tennessee State Budget.
** These classifications differ from those displayed on page A-6 of the FY 2016-2017 Budget. Please see the methodology notes online for additional information our specific categorizations.*

By most accounts, Tennessee is considered a low tax state. In terms of state tax revenues alone, **the state collects about $2,200 per Tennessean to pay for the state's programs and services – the 3rd lowest per person tax load in the country**.[iii] Total state tax collections represents just under 5% of total state personal income.

States primarily collect tax revenues through sales taxes, income taxes, and corporate taxes. In Tennessee, state tax revenues are predominately collected through sales taxes (55%) and corporate taxes (14%).

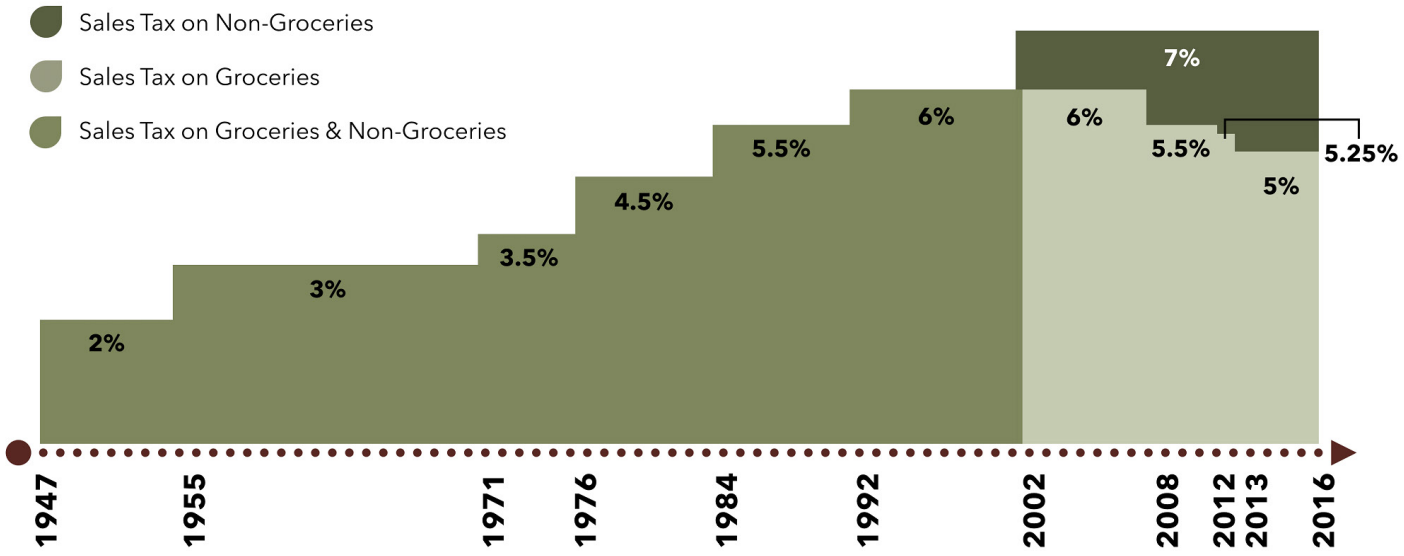
The state's tax revenues are shared with cities and counties. These amounts are included in the general government expenditure category in this primer. In FY 2016-2017, for example, 8% of the Department of Revenue's total collections are expected to be transferred to cities and counties. The specific proportion of collections and the method for allocating them across cities and counties varies with each individual tax.

GENERAL SALES TAX

Tennessee's broad-based general sales and use tax is the state's single largest source of state tax revenues. As with all taxes, the amount that the state brings in from the sales tax is impacted by both the tax rate – the percent at which sales are taxed – and the tax base – the number and value of purchases that are taxed. These concepts are important to understand, because a broad base with a low rate could, for example, bring in the same dollars as a narrow base with a high rate. Additionally, unintended changes to the tax base could compromise revenues.

SALES TAX RATE: The sales taxes paid by Tennesseans and visitors making certain purchases in Tennessee are a combination of the state sales tax and an optional county and municipal sales tax add-on, known as the local option. The timeline below shows the history of Tennessee's state sales tax rate from its inception in 1947 to today.

TENNESSEE STATE SALES TAX RATE TIMELINE



Note: This timeline excludes local sales taxes.

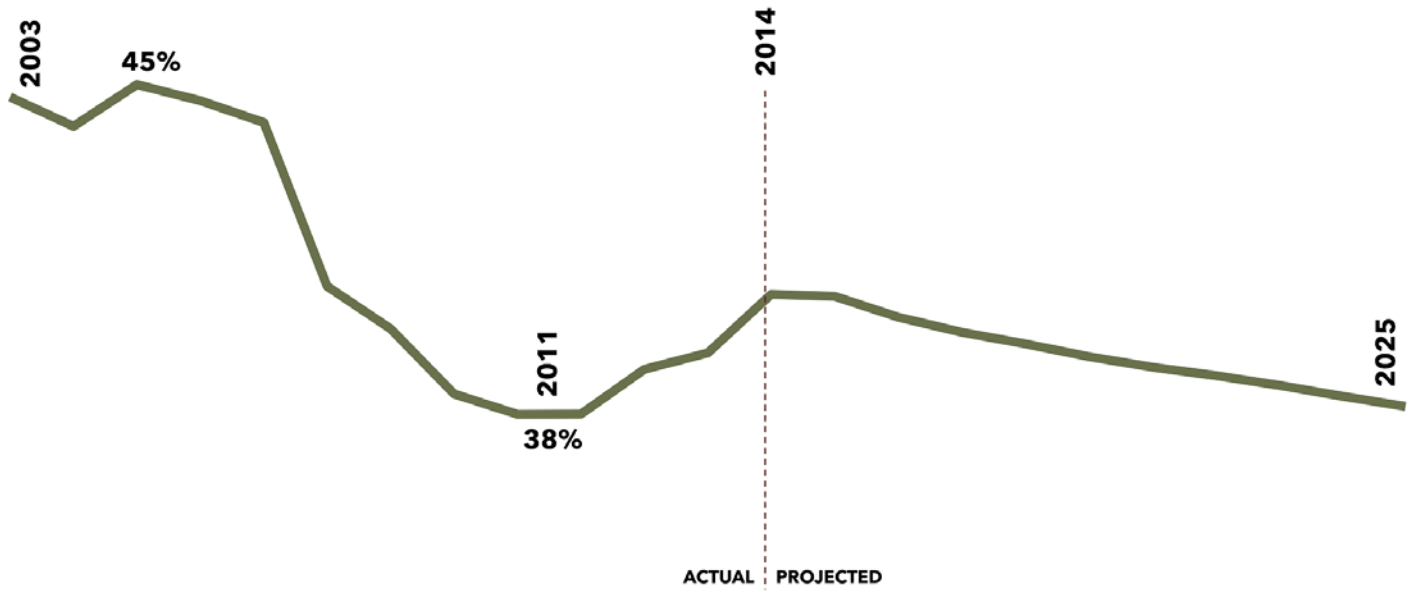
The state sales tax rate hasn't been increased in almost 15 years, while the purchase of groceries has actually received a tax reduction during that period. Today, most purchases are taxed at 9.75% – which includes a 7% tax by the state and another 2.75% by most of the state's counties.[iv] **Tennessee has the highest average combined state and local sales tax rate in the country.**[v] Groceries are taxed two percentage points lower than other goods, or 7.75% in most cases. Tennessee is among 13 states that tax groceries.[vi]

SALES TAX BASE: Over the last two decades, people's purchases have increasingly shifted from physical stores to online merchants and from goods to services, and the trends continue. Because many services and online purchases are exempt from most sales taxes, these trends are shrinking states' sales tax bases and compromising an important revenue stream.[vii] This impact is particularly meaningful for Tennessee, as we rely more heavily on sales tax than do most other states.

Tennessee's sales tax base is expected to grow by as much as 40% over the next decade.[viii] However, this metric doesn't fully capture how much the state would be collecting in the absence of these trends as purchasing power grows in the state. The figure below shows the inflation-adjusted sales tax base as a percent of the state's total personal income. As our state's aggregate personal income grows as a result of both higher earnings and population growth, we would expect more spending in Tennessee. This analysis helps show how much of this overall spending is being spent on items subjects to the state's sales tax. From this perspective, Tennessee has experienced a recent uptick in the sales tax base primarily from increasing hotel prices and stays and car sales.[ix] **The overall trend is that the state's sales tax base is expected to decline as a percent of personal income in the coming years.**

The Budget's sales tax collections have fallen from 5.6% of personal consumption spending in 1997 to around 3.5%. To understand where we're headed, ideally, we would look at projections of this same metric. However, those projections are not available; so we use projections of the total state personal income as a proxy.[4]

TENNESSEE TAXABLE SALES AS A PERCENT OF PERSONAL INCOME



Sources: The Sycamore Institute's analysis of "Table 1: Selected U.S. and Tennessee Indicators, Seasonally Adjusted – Forecast Data" and "Table 1: Selected U.S. and Tennessee Indicators, Seasonally Adjusted – Historical Data" from An Economic Report to the Governor of the State of Tennessee: The State's Economic Outlook, January 2016 by UT Knoxville's Center for Business and Economic Research.

In Tennessee, the sales tax does not apply to most services – including things like health care, personal care, and home maintenance and construction services. The sales tax also does not apply to online purchases from businesses without a physical presence in the state. In fact, according to a 1992 U.S. Supreme Court ruling, online retailers without a physical presence cannot be required to collect state or local sales taxes.[x] This restriction costs Tennessee as much as $450 million in sales tax collections each year. The current Supreme Court has signaled that it may be open to reversing the 1992 opinion.[xi] Joining at least 11 other states to challenge the 1992 ruling, the Tennessee Department of Revenue proposed a rule in 2016 to expand the state's sales tax to all online retailers with at least $500,000 in Tennessee sales, potentially increasing state tax revenues by at least $200 million per year.[xii] If finalized and then challenged, this could enable the Supreme Court to overturn the 1992 ruling, which could broaden the state's sales tax base – providing the opportunity to increase revenues and/or to reduce the sales tax rate.

CORPORATE TAXES

Corporate taxes generally refer to taxes on the profits of firms and businesses. Tennessee's franchise and excise taxes are corporate taxes and make up 14% of the state's tax revenues. The excise tax is 6.5% of the net earnings of Tennessee for-profit businesses. The franchise tax is 0.25% of the net worth or real and tangible property of Tennessee businesses. **Tennessee's per capita corporate tax collections are the 11th highest in the country**.[xiii]

INDIVIDUAL INCOME TAX

Tennessee doesn't have a broad-based individual income tax but does tax the interest and dividends from investments under what is known as the Hall Income Tax. In the 2016 legislative session, the General Assembly reduced the Hall Income Tax rate from 6% to 5% beginning in 2016 and required full repeal of the tax by 2022. Although not legally binding, the legislation specifies that the intent is to phase it out through a one percentage point reduction each year until it is eliminated. The Hall Income Tax accounts for about 2% of state tax revenues. Full elimination of the tax is expected to reduce state and local revenues by about $257 million annually beginning in FY 2022-2023.[xiv]

Tennessee is among nine states that have little or no individual income tax.[xv] After winning approval from voters on the 2014 ballot, an amendment was added to the state constitution prohibiting the Legislature from instituting any new tax on earned income.

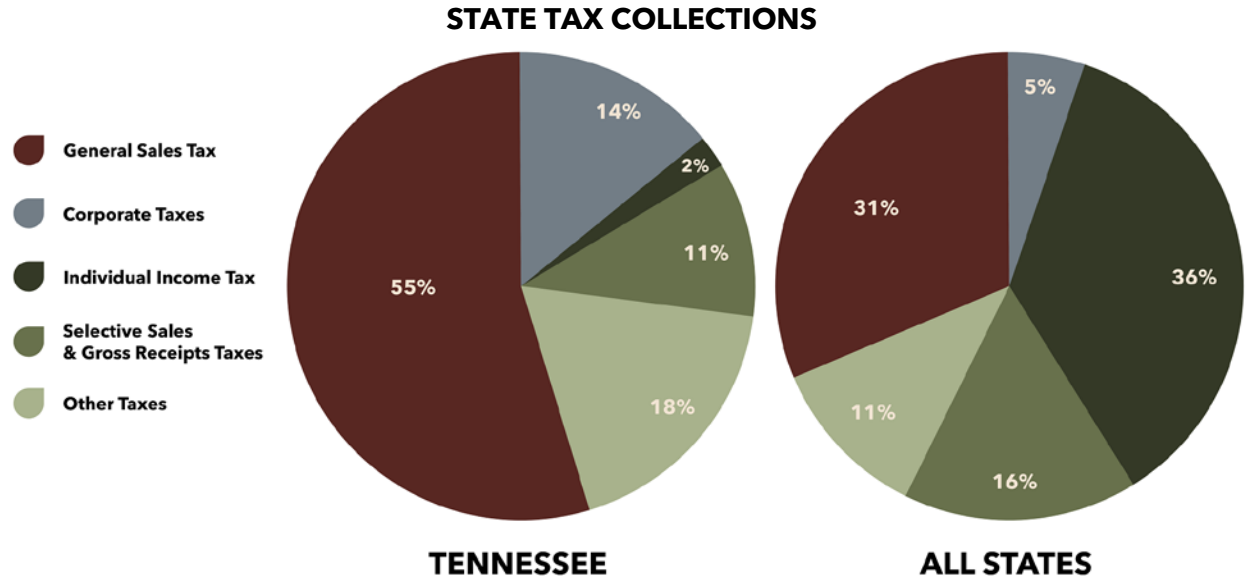
SELECTIVE SALES & GROSS RECEIPTS TAXES

Tennessee taxes the sale or use of some specific items or types of businesses at a different rate. Gross receipts taxes tax the gross earnings of select times of businesses or services – including bars, electric companies, and soft drink bottlers. Specific types of sales taxes, often referred to as excise taxes, are levied on things like gas and fuel, alcohol, and cigarettes. In Tennessee, gas is taxed at a rate of $0.20 per gallon – a rate that was set in 1989. **Tennessee has the 12th lowest gas tax in the country**.[xvi]

Excise or selective sales taxes on items like alcohol and cigarettes are often referred to as "sin" taxes. For example, **tobacco is taxed at $0.62 per pack, which is the 11th lowest rate in the country**.[xvii]

IN CONTEXT

Putting all this information in context, Tennessee relies more on general sales tax and corporate taxes and less on income tax than do other states, on average.

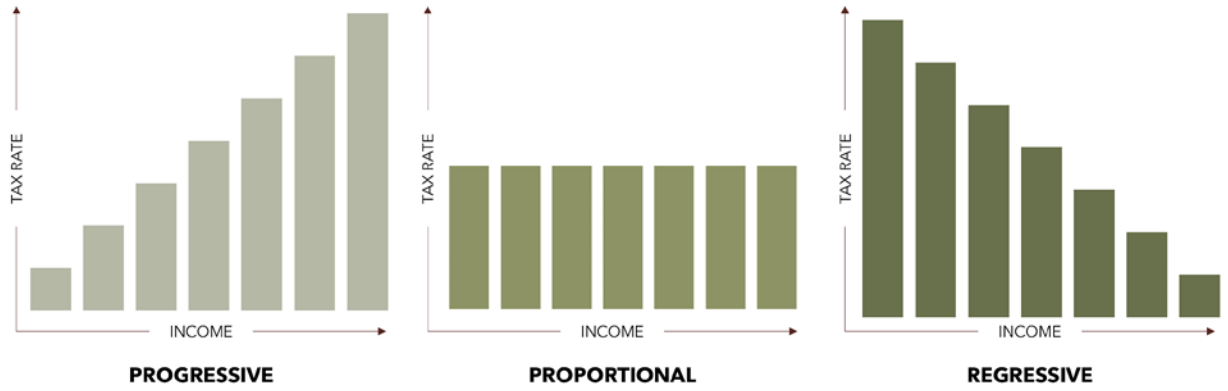


Sources: The Sycamore Institute's analysis of "Comparison Statement of State Revenues" table from the FY 2016-2017 Tennessee State Budget. Cheryl Lee, Edwin Pome, Mara Beleacov, Daniel Pyon, and Matthew Park, "State Government Tax Collections Summary Report: 2014," Economy Wide Statistics Brief, U.S. Census, April 16, 2015.

WHO PAYS STATE TAXES?

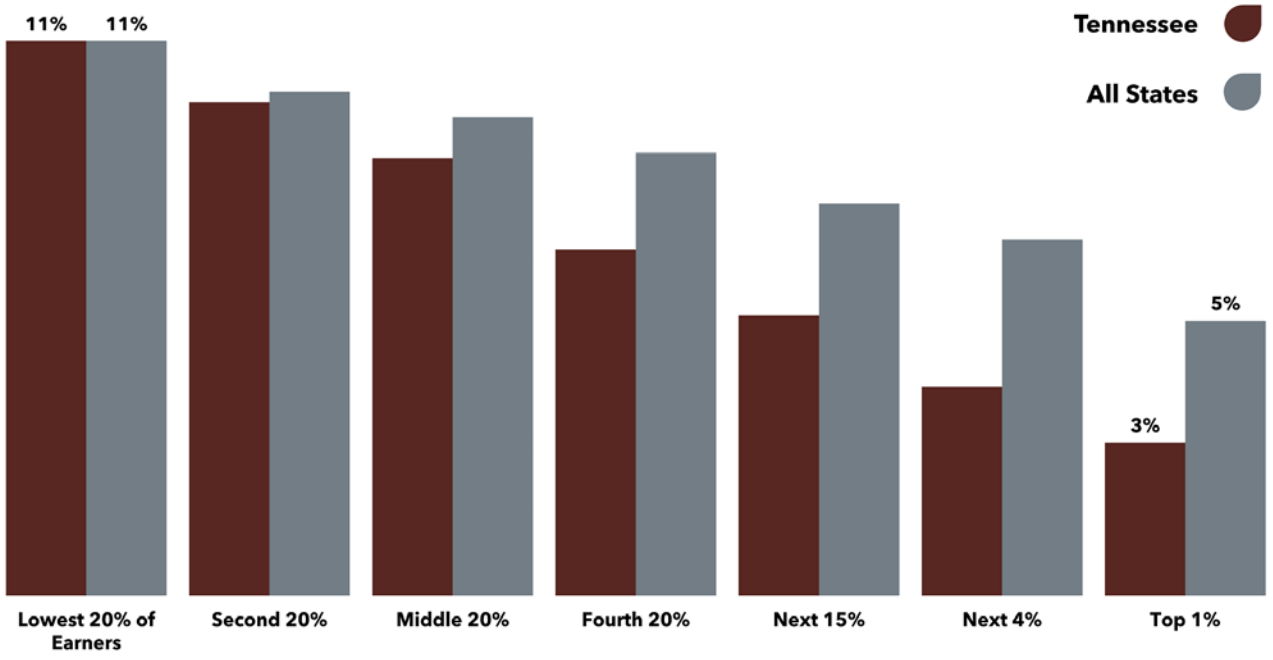
Of course, in practice, state taxes affect people differently based on their circumstances. Tax structures are often categorized based on their "vertical equity" – i.e. how they hit individuals at various income levels. When tax loads as a proportion of income are higher for higher income level individuals and lower for lower income levels, the tax structure is referred to as progressive. When tax loads are lower for higher income individuals and vice versa, the tax structure is considered regressive. When tax rates are the same across all income levels, the tax structure is proportional. The figures below illustrate each of these three kinds of tax structures.

ILLUSTRATIVE TAX STRUCTURES



The federal tax structure is progressive because it relies most heavily on income taxes that impose progressively higher rates as an individual earns more money. By contrast, almost all state tax structures tend to be regressive because states rely more heavily on sales taxes. Those that tax necessities like groceries tend to be more regressive than those that don't. This is because lower earners spend more of their income than higher earners, which means more of their income is subject to taxation. The figure below shows how state and local taxes impact different earners differently for both Tennessee and all states on average.

AVERAGE STATE AND LOCAL TAX LOAD BY INCOME LEVEL



Source: Institute on Taxation and Economic Policy, "Who Pays? A Distributional Analysis of the Tax Systems in all 50 States, Fifth Edition," January 2015.

HOW ARE WE DOING?

NATIONAL CONFERENCE OF STATE LEGISLATURE'S PRINCIPLES FOR EVALUATING A STATE TAX SYSTEM[5]

Over the past three decades, the National Conference of State Legislatures (NCSL) has worked collaboratively with its members to establish and update a set of principles that states can use to evaluate and modify their revenue systems. NCSL acknowledges that different states will place different levels of importance on each of the following principles:

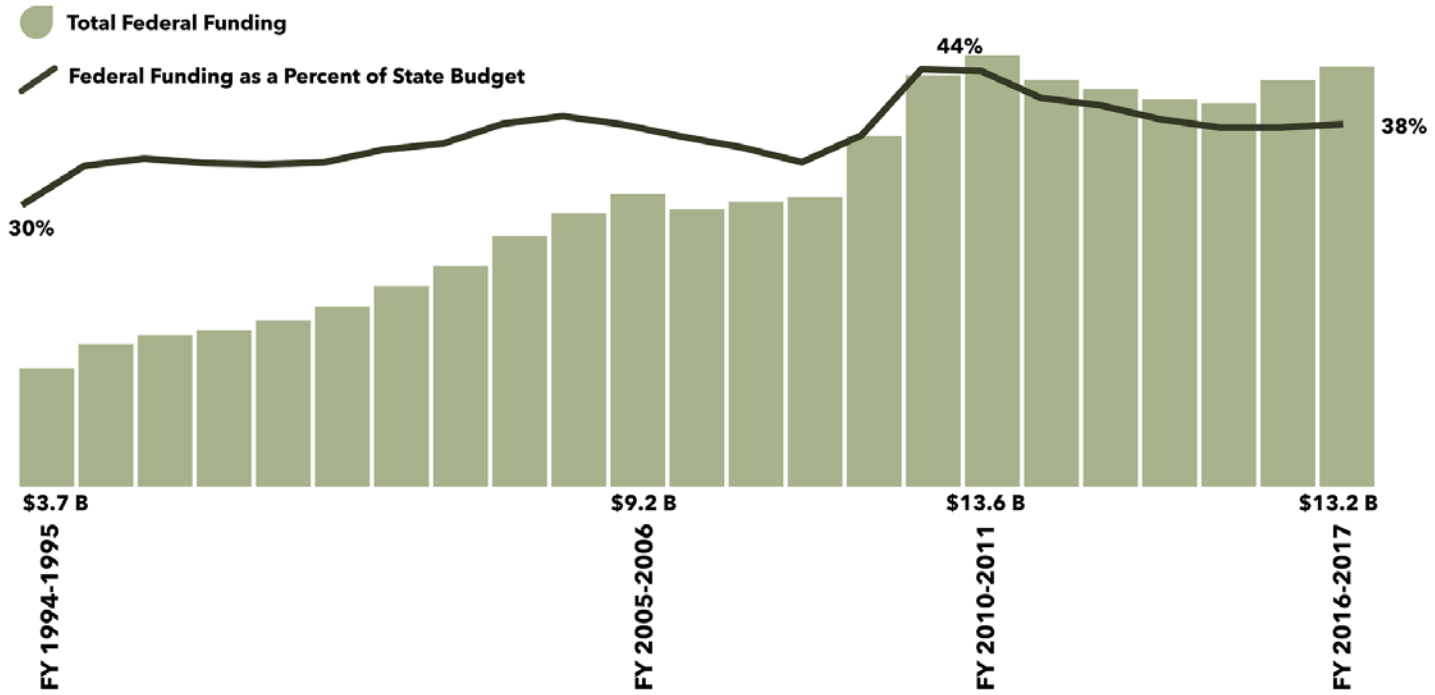
- **Reliability**
  - Are revenues relatively stable and constant over time?
  - Are changes to the tax system kept to a minimum?
  - Are revenues sufficient to finance spending over time?
- **Balance**
  - Is there a balanced mix of taxes?
- **Equity**
  - Are people in similar circumstances taxed similarly?
  - How are tax loads distributed across people at different income levels?
- **Compliance and Administration**
  - Is it easy to understand and comply with the tax laws?
  - Is it costly for the state to collect and enforce taxes?
- **Responsiveness to Interstate and International Competition**
  - How do the tax policies of surrounding states impact the revenue potential of various state taxes?
- **Economic Neutrality**
  - Unless clearly articulated, does the system unintentionally influence behavior to avoid or evade taxes?
- **Accountability**
  - Are tax laws and changes publicly available and transparent?
  - Do policymakers regularly examine the effectiveness of tax policies in accomplishing the goals they were established to accomplish?

See page 40 for a full list of sources.

DIGGING DEEPER:

FEDERAL FUNDING

TOTAL FEDERAL FUNDING IN THE TENNESSEE BUDGET



Sources: "Total State Budget: Comparison of Programs and Revenue Sources" table from the FY 1996-1997 - FY 2016-2017 Tennessee State Budgets

The recommended Budget for FY 2016-2017 included $13.2 billion in funding from the federal government. These amounts peaked in FYs 2009-2010 and 2010-2011, when the U.S. Congress – through the American Recovery and Reinvestment Act (ARRA) – provided an infusion of one-time federal funds to help states recover from the Great Recession.

Of every dollar currently spent by the state of Tennessee, 38¢ comes from the federal government (see page 6). Tennessee relies more heavily on federal revenues than any other state except Mississippi, Arizona, and Michigan.[xviii]

These dollars represent only those in the state Budget – not *all* the federal dollars being spent to serve Tennesseans. In state FY 2015-2016, for example, the Budget included $12.8 billion in federal funds, but in federal FY 2016, an estimated $66.4 billion in federal funds were sent into Tennessee via direct awards, contracts, and benefits.[xix]

FEDERAL FUNDS IN THE STATE BUDGET

Federal funds awarded directly to the departments and agencies of the state government to carry-out programs and deliver services are included in the state Budget. Examples include Medicaid, Temporary Assistance for Needy Families (TANF), block grants for substance abuse and mental health prevention and treatment, the Army and Air National Guards, and clean water activities.

FEDERAL FUNDS NOT IN THE STATE BUDGET

Other federal funds are awarded directly to local governments or non-governmental organizations to carry-out programs and deliver services or are made as direct payments or benefits to individuals. These are not included in the state Budget. Examples include Medicare, Social Security, Pell Grants, and grants for scientific research.

Some funding is awarded to *both* states and other organizations. For example, federal support for transportation, education, and housing are all provided to the state *and* directly to local governments. Only the funds awarded directly to the state government are included in the state Budget.

DIGGING DEEPER:

"STRINGS ATTACHED"

A sizable portion of the Tennessee state Budget's revenues has some fairly serious strings or limitations attached. For example, the nearly 40% of our state budget that is federal funding comes with many restrictions. Some strings limit the amount of discretion that either the Governor or the General Assembly has to adjust numbers. Other strings can amplify the effects associated with a given state funding decision.

18%

The proportion of the total General Fund that was considered discretionary in FY 2015-2016.

State-Level Earmarks: First, the use of some state revenue streams are dictated – or "earmarked" – in permanent law. For example, about 55¢ of every 62¢-tax paid on a pack of cigarettes goes to the Education Fund. The money in these funds can only be used for their designated purposes. Lottery proceeds, for example, can only be used for college scholarships and a handful of other education expenses.

Federal Limits on Spending Purpose: All federal funding is awarded to states for specific purposes, and state governments often have limited authority to repurpose those dollars. For example, the nearly $2 billion that comes into the state from the federal government for the Supplemental Nutrition Assistance Program (SNAP) (commonly referred to as food stamps) within the Department of Human Services cannot be spent by the Department of Correction on state prisons. In fact, SNAP dollars must be spent in a very particular way.

The federal government's "strings" can also place a price tag on non-budgetary decisions. Prime example: The recent change in DUI laws for underage drinkers put $60 million in federal funding at risk and required a special legislative session to untangle.

Federal Matching Requirements: Furthermore, the federal government almost always requires the states to pitch-in in the form of matching and/or maintenance-of-effort requirements – meaning state dollars must also be invested in the program alongside federal dollars. Matching provisions also multiply the impact of state funding decision. For example, 65% of most of TennCare (i.e. Tennessee's Medicaid program) costs are covered by the federal government. So, for every state dollar put into TennCare, the state receives $1.54 from the federal government, and for every state TennCare dollar cut, the overall Budget falls by $2.54.

Court Mandates: Additionally, the outcomes of lawsuits can play a significant role in placing funding obligations on the state. For example, in ongoing court challenges that began in the 1980s, local school systems charged that the state education funding allocations were inadequate. The courts agreed. The result was a court-mandated funding formula for public education in Tennessee known as the Basic Education Program (BEP).

Double Counting: Finally, some of the money you see in the Budget is actually accounted for in multiple locations because departments provide services and supplies to one another. For example, departments often pay the Department of General Services to "rent" office space in state-owned buildings. In this example, those dollars show up in the Budget for both departments – as expenses for departments paying the rent and as departmental or "other" revenue for the Department of General Services.

Why Understanding Strings is Important: According to the Budget, about $5.4 billion in recurring state expenditures were considered discretionary for the purposes of budgeting for FY 2016-2017. This amounts to 18% of the total FY 2015-2016 General Fund and 41% of the state appropriation portion of the General Fund.[xx] This is referred to in the Budget as the "discretionary base." **The discretionary base tends to be the most scrutinized in annual spending decisions**, and even within that, the most attention is paid to incremental changes to these numbers rather than the base itself.

DIGGING DEEPER:
DEFICITS & SURPLUSES

Policymakers are responsible for the state's fiscal health in both the short-term and long-term. The constitutional balanced budget requirement creates the obligation for policymakers to evaluate a constant stream of difficult trade-offs on an annual basis. Even with the best year-to-year and mid-year estimates about taxing and spending, both unexpected economic conditions and underlying trends in a state's tax and spending decisions have the potential to back state policymakers into a corner. Understanding how these dynamics work and the tools at state policymakers' disposal is important because these scenarios can potentially force difficult choices about taxing and spending.

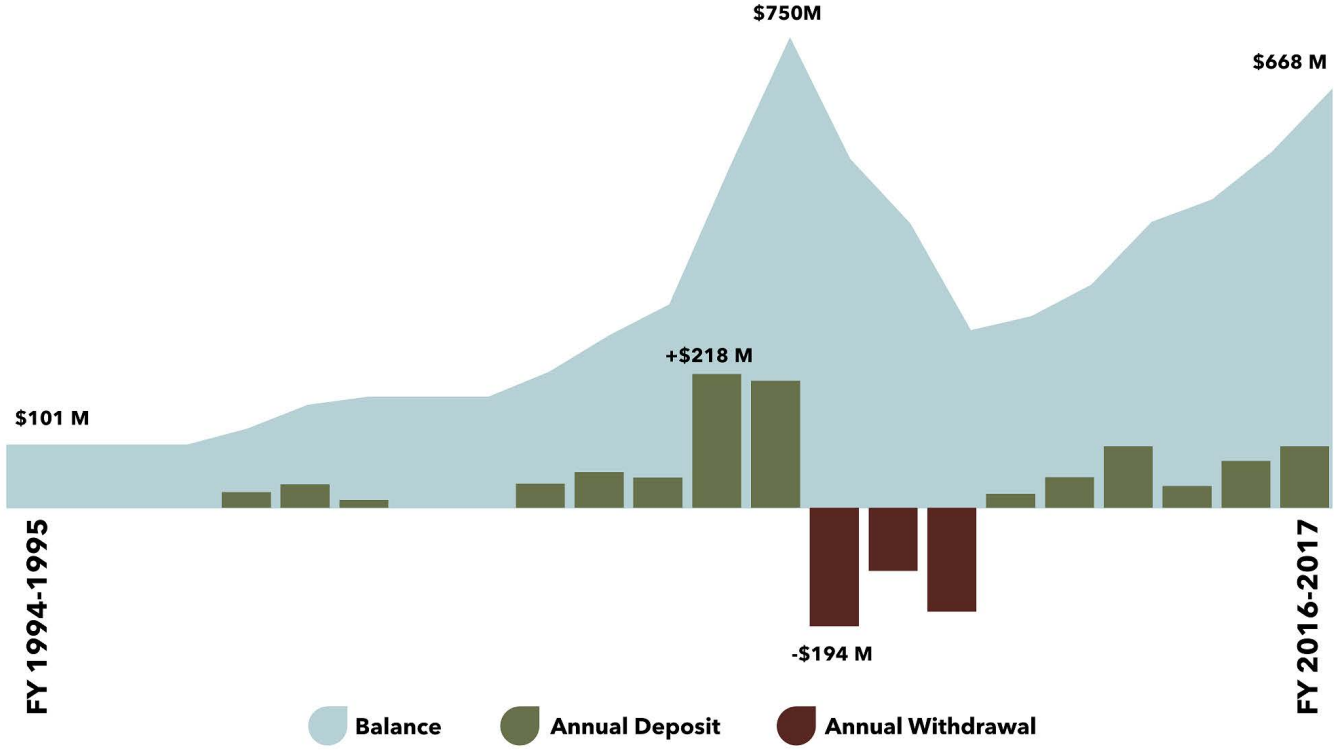
CYCLICAL DEFICITS

Imbalances between revenues and expenditures that occur because of economic downturns are known as cyclical deficits. Let's take, for example, the Great Recession that lasted from 2007 to 2009. During and immediately after the recession, Tennessee had higher-than-usual need for the programs and services funded by the Budget with fewer-than-usual resources to fund them.

Because personal income falls during recessions, smaller paychecks mean fewer dollars for personal spending and lower sales tax revenues for the state. At the same time, more people may need state-funded programs to help them bridge the gap until conditions improve. In FY 2008-2009, for example, Tennessee sales tax revenues fell by nearly 8% or over half a billion dollars from the prior year. Meanwhile, enrollment in TennCare jumped by 4% – which, at the time, was the highest annual enrollment increase in a decade.[xxi]

Fortunately, states have a tool that helps smooth out the ups and downs of the economic cycle. Reserves – also known as rainy day funds – allow states to shore up funding when revenues are flowing well and/or needs are relatively low. Those reserves can then be tapped when revenues falter and/or needs increase. In Tennessee, these reserves are called the Reserve for Revenue Fluctuations.

TENNESSEE RESERVE FOR REVENUE FLUCTUATIONS



Sources: The Sycamore Institute's analysis of the FY 1996-1997 - FY 2016-2017 Tennessee State Budgets

The Reserve for Revenue Fluctuations is not the only vehicle at the state's disposal for saving money to use in tight years. For example, the TennCare Reserve is a separate reserve that holds excess funds specifically for TennCare. In dire situations, the Legislature can allow these savings to be used to help out both TennCare and the General Fund. The TennCare Reserve was an estimated $283 million at the end of FY 2015-2016.[xxii]

The Great Recession proved a worthy foe to most states' rainy day funds. Despite the infusion of additional federal dollars for everything from highway projects to state Medicaid programs like TennCare, nearly all states enacted some combination of program and spending cuts, tax and fee increases, and reserve taps. In FY 2009-2010, for example, 45 states cut their General Fund expenditures – including 39 that made cuts mid-year.[xxiii] By the end of FY 2012-2011, 22 states had

HOW ARE WE DOING?

CONSENSUS RAINY DAY FUND BEST PRACTICES[6]

States that employ best practices in managing their rainy day funds adhere to the following principles on which multiple sources agree:

- Funds should have an explicit purpose defined in law, because it helps provide states guidance as they consider how much to save and when, why, and how to tap savings.
  - According to law, the purpose of Tennessee's Reserve for Revenue Fluctuations is "to meet unexpected shortfalls of revenue or to meet expenditure requirements in excess of budgeted appropriations levels."
- States should regularly evaluate and project how revenues and spending change over time and when and why they may be unexpectedly high or low, because it helps inform longer-term savings and spending strategies.
  - Tennessee does not have a formally-established process for making long-term projections.
  - In the midst of and just following the Great Recession, the Budgets for FY 2009-2010 through FY 2013-2014 included multi-year projections of revenue and spending growth, but recent Budgets have not included similar projections.
- States should set criteria for proactively making Rainy Day Fund deposits rather than relying on unplanned surpluses, and the criteria should allow for bigger deposits to be made when revenues spike.
  - Under state law, the Budget must recommend deposits that are at least 10% of growth in state tax revenues for the General and Education Funds until the balance is equal to at least 8% of state tax revenue collections for the General and Education Funds. This means that when revenue growth is high, more dollars make their way to the Reserve for Revenue Fluctuations.
- Rainy Day Funds should not be capped at an amount that may limit a state's ability to weather a protracted recession. Rainy Day Fund convention used to be about 5% of a state's budget, but based on the experience of states during the most recent recession, many have agreed that 5% may be too low. In fact, the organizations that assign state government credit ratings – Standard and Poor's and Moody's – provide the highest ratings to states that save 8-10% of annual revenues.
  - Tennessee law does not explicitly place a cap on the Reserve for Revenue Fluctuations but requires that the Governor recommend deposit amounts in the Budget aimed at maintaining a Fund that is equal to about 8% of revenues.
  - Since the state began rebuilding the Reserve for Revenue Fluctuations and the TennCare Reserve in FY 2011-2012, together they have averaged about 6% of revenues each year. Based on the most recent Budget's estimations, at the end of the last fiscal year, the Reserve was still about $164 million short of the 8% target.
- States should provide flexibility to use Rainy Day Funds to respond to downturns. Strategies like requiring a 60% vote of the legislature or capping withdrawals may limit that flexibility.
  - When Tennessee's Reserve for Revenue Fluctuations is needed to pay for expenses that exceed the amounts in the appropriations bill, the state statute allows the Commissioner of Finance and Administration to tap the greater of half of the Reserve or $100 million.
  - There are no statutory limits when funds are needed to pay for already appropriated expenditures because of revenue shortfalls, but the law expresses legislative intent that spending should be cut before turning to the Reserve.
  - The law requires legislative notification and a committee hearing under either scenario, but doesn't specifically require a vote of the General Assembly.
- States should establish rules for replenishing the Rainy Day Fund when it is tapped.
  - Tennessee law requires that the Governor annually recommend deposits to the account aimed at achieving/maintaining a balance of 8% of state tax dollars.

See page 40 for a full list of sources.

completely or nearly completely (i.e. $10 million or less) depleted their rainy day funds.[xxiv] Tennessee tapped nearly $800 million from both the Reserve for Revenue Fluctuations and the TennCare Reserve over the course of the recession and recovery but, unlike many other states, never depleted either reserve. Instead, the state balanced its use of reserve dollars, which are considered a non-recurring source of revenue, with recurring base spending reductions and state employee salary freezes.

When accounting for both reserves, Tennessee could cover state government operations at current Budget funding levels for around 23 days. By the end of FY 2016-2017, the balance in the two reserves is expected to total over $900 million. Although this is the highest level of reserves the state has had in years, the anticipated balances are nearly $200 million less than the amounts stowed away going into the Great Recession.

Even though the state never depleted its Reserve, Tennessee bolstered the laws governing the Reserve for Revenue Fluctuations in the wake of the recession in order to raise the target Reserve balance (see page 31).

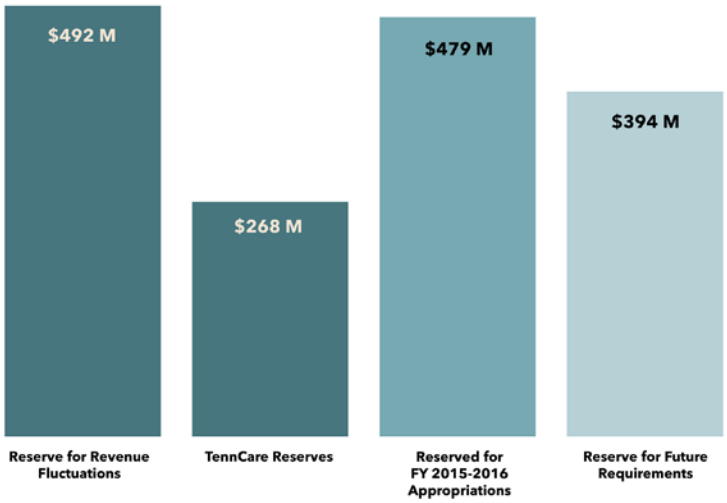
Although it feels like yesterday, it has actually been over seven years since the Great Recession officially ended. Over the last 150 years, the average time between recessions in the U.S. has been just 3 years, so some say we're due for another sometime soon.[7]

SURPLUSES

Although the Reserve for Revenue Fluctuations might be viewed as a savings account of sorts, any differences between spending and collections aren't simply deposited to the Reserve. In fact, each year's appropriations bill specifies a target balance for the Reserve, which dictates the size of the deposit that year regardless of whether the state could conceivably "afford" more based on its actual spending and collections.

Many appropriated programs have reserves in any given fiscal year. These program reserves represent the difference between any revenues available for the program and actual spending. In some cases, programs are able to keep and roll these reserves over from one year to the next. Mostly, however, these unspent funds revert back to the General Fund for re-appropriation for other purposes in future years.

SELECT GENERAL FUND RESERVES AND SURPLUSES FY 2014-2015



Sources: The Sycamore Institute's analysis of "General Fund Comparative Balance Sheet: July 30, 2014 and July 30, 2015" from the FY 2016-2017 Tennessee State Budget.

In addition to these so-called "reversions," the General Fund also accumulates dollars when revenue collections outpace budgeted estimates - an issue inextricably tied with revenue estimation (discussed on page 10). Some excess collections may be reserved specifically for the next fiscal year; while others are combined with program reversions in the Reserve for Future Requirements. This latter reserve is often referred to as the surplus. At the end of FY 2014-2015, these two reserves totaled $873 million - $479 million was reserved for FY 2015-2016 and $394 million was surplus. All told, these reserved funds and surpluses along with the Reserve for Revenue Fluctuations and the TennCare Reserve totaled over $1.6 billion at the end of FY 2014-2015.[xxv]

Trade-Offs: There are trade-offs involved with both savings and surpluses. While savings are stowed away for hard times, other surpluses become available to be re-spent in the next fiscal year as a source of non-recurring revenues – even though they were accumulated from regular recurring revenue sources. For these reasons, both savings and other surpluses aren't available for recurring investments in programs and services or cuts to taxes.

STRUCTURAL DEFICITS

When the spending and revenues are out of balance even when times are good, it is referred to as a structural deficit. A structural deficit could present itself either as current underspending or as a projected future budget gap. In the first case, spending may be limited to a level that is within revenue constraints but below what may be warranted. In the second, the growth of revenues and the growth in spending diverge.

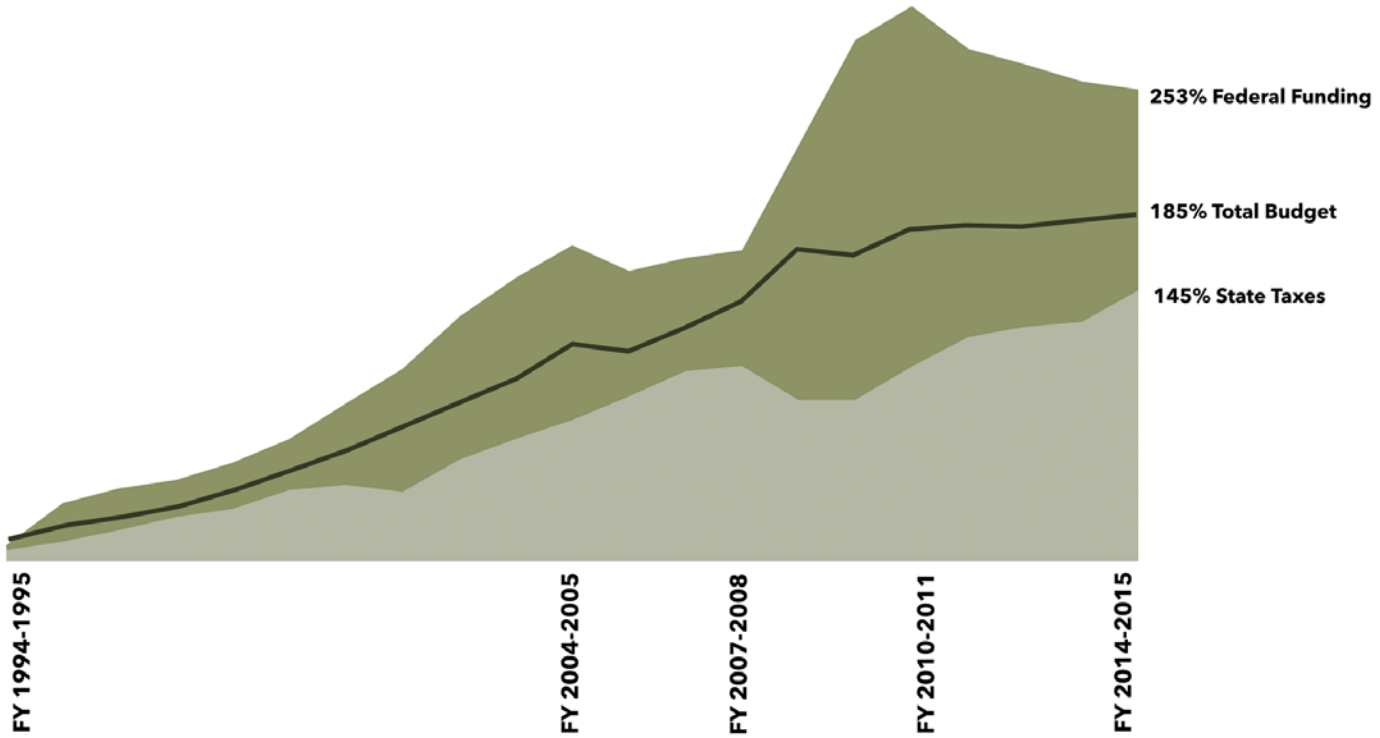
In the case of the federal government, it is easy to identify the structural deficit in the form of growing national debt. However, under balanced budgeting it can be hard to tell if a structural deficit exists because expenditures for certain programs can be constrained regardless of the need or demand for them. In this section, we explore a few potential metrics to identify a structural deficit.

One potential approach is to take a look back at how the state's revenues have grown over time relative to state spending. For example, since FY 1993-1994, Tennessee's state tax revenues grew by a total of 145% while expenditures grew by 185%. The difference, of course, has been offset by other revenue sources – namely the 253% cumulative growth in federal resources. It is difficult to objectively discern if the state's need for programs and services is outstripping the ability to pay for it with the state's own resources or, alternatively, if spending is simply growing faster than state tax revenues because of the availability of federal dollars.

Another avenue for identifying a structural deficit is by looking forward – in other words, using multi-year projections of revenue collections and spending needs. The Budget does not include multi-year projections for either revenues or expenditures, and we've already discussed how difficult the task of projecting revenues is even one year out. Recent experience, however, suggests that our state tax revenues are on the mend. In fact, by the end of 2016, Tennessee's tax revenues were up 8% over peak collections in 2008 – even when adjusted for inflation.[xxvi] Last fiscal year, revenue collections exceeded projections by 7% – growing by nearly 7% from the prior year.[xxvii]

On the spending side, most agree that multi-year spending projections should be based on maintaining

CUMULATIVE BUDGET AND REVENUE GROWTH SINCE FY 1993-1994



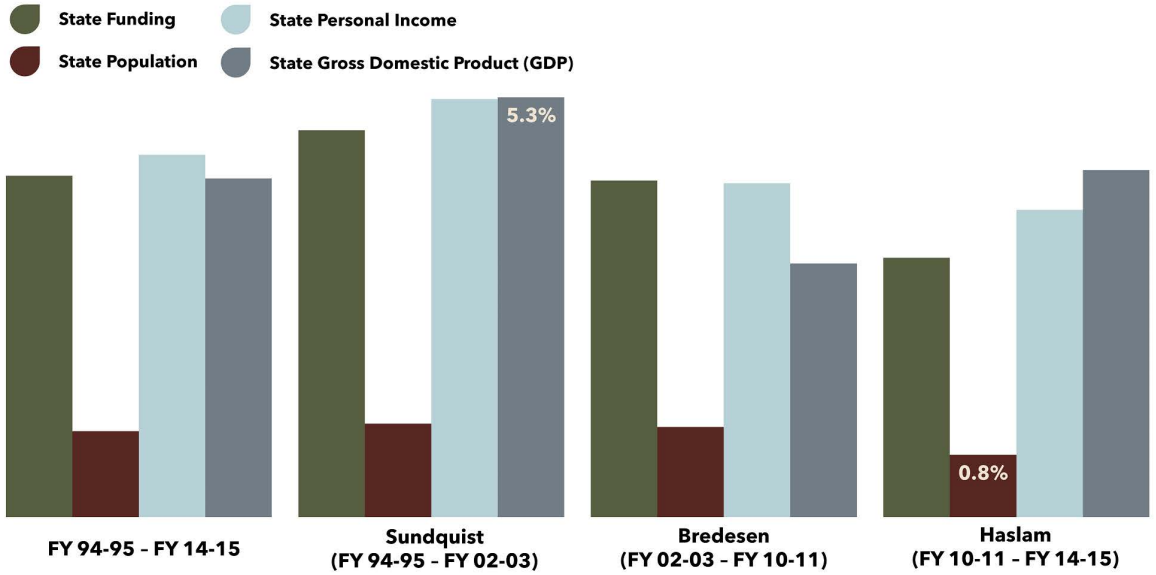
Sources: The Sycamore Institute's analysis of "Total State Budget: Comparison of Programs and Revenue Sources" and "Comparison Statement of State Revenues" from the FY 1996-1997 – FY 2016-2017 Tennessee State Budgets.

current services, but states approach the task differently.[xxviii] Under no circumstance in Tennessee do recurring expenses automatically grow as part of the base budget. However, each year's Budget includes new recommended cost increases to the recurring base budget associated with items that are non-discretionary for one reason or another – like TennCare and the Basic Education Program. These annual cost increases are based on the underlying requirements and conditions driving their non-discretionary status (e.g. expected enrollment and health care cost increases). Other recurring items, however, do not receive perennial recommended cost increases, even though some would argue that increased spending would be necessary to maintain the current level of service or effort due to factors like inflation, population growth, and infrastructure deterioration. In fact, last year, the Legislature's research arm identified over $6 billion in needed but unfunded transportation projects,[xxix] and the Tennessee Advisory Commission on Intergovernmental Relations (TACIR) recently estimated that the state needs $41.5 billion of public infrastructure improvements through 2019.[xxx]

In the absence of reliable projections, some have identified other ways to recognize a structural deficit. One way is pinpointing certain warning signs for structural deficits – that is, features of a state tax revenue system that may contribute to structural deficits because they either compromise revenue growth or cause spikes in the need for spending. Some of these include things like sales taxes that exclude services or internet sales (see discussion on page 24), age-related tax breaks, and constitutional or statutory tax or spending limits.[xxxi] The state's Comptroller, for example, has pointed to the sales tax as an indicator of a structural deficit – specifically, that state sales taxes have traditionally been increased every six to eight years to keep up with the growth in government expenses.[xxxii] The last time that the state increased the sales tax rate was in 2002, and recently, sales taxes on groceries and income taxes on dividends have been cut.

Others point to proxies like inflation or population growth to model how state spending should grow to meet needs. The figure below shows Tennessee's average annual state spending growth since FY 1994-1995 and within the last three gubernatorial administrations. This information is shown alongside average annual growth in a few measures that might drive or illustrate demand for state programs and services. These include state population, state personal income, and the overall state economy (i.e. the gross domestic product or GDP). Tennessee's constitution limits the growth in Budget expenditures paid for with state taxes from year to year to no more than the growth in the state's personal income. However, the requirement can be overridden with a simple majority vote of the General Assembly.

AVERAGE ANNUAL BUDGET GROWTH vs. OTHER GROWTH FACTORS



Sources: The Sycamore Institute's analysis of "Comparison of Programs" from the FY 1996-1997 – FY 2016-2017 Tennessee State Budgets.
U.S. Census Bureau, Mid-Year State Population Estimates as of December 2015.
UT Knoxville Boyd Center for Business & Economic Research, "Annual Projections: Total Population for Tennessee Counties: 2011 to 2064."
Bureau of Economic Analysis, "SA1 Personal Income Summary: Personal Income, Population, Per Capita Personal Income."
Bureau of Economic Analysis, "Gross domestic product (GDP) by state (millions of current dollars)."

FREQUENTLY ASKED BUDGET QUESTIONS

DO THE RECOMMENDED NUMBERS IN THE BUDGET REPRESENT ACTUAL SPENDING AND COLLECTIONS?

Usually, no. There a few reasons that the numbers in the Budget may differ from actual spending and collections:

- First, the Governor almost always proposes an Administration Amendment that includes changes to the Budget in March or April. Given the time that passes between when the Budget is prepared and delivered and when appropriations are actually passed, the Administration will submit an amendment to the Budget that includes any updated estimates and policy changes. (See page 11.)
- Second, the General Assembly appropriates a different amount than what was recommended by the Governor. (See page 9.)
- Third, the appropriations act gives departments some flexibility for Budget adjustments related to the collection of dedicated taxes and fees and unexpected federal grants. (See page 11.)
- Fourth, the numbers in the Budget are estimates. Because collected revenues will almost certainly be different than what was estimated, spending decisions may also be different in order to ensure a balanced budget (i.e. the underspending issue discussed on page 11). Additionally, in most years, the state will collect more than it needs to cover expenses in that year. The excess revenues are either deposited in a rainy day fund – a reserve that may need to be tapped in future years if revenue collections fall short – or rolled over and available for re-budgeting in the next year. (See pages 30-32.)
- Fifth, there is the over-appropriation issue discussed on page 9 that all but guarantees actual expenditures will differ from recommended budget levels.
- Finally, the Administration will often submit a supplemental appropriation request with the next annual Budget document that increases current year appropriations above the amounts in the prior Budget. (See page 11.)

HOW CAN I BETTER UNDERSTAND THE RECOMMENDED BUDGET'S STATE FUNDING CHANGES FOR A PROGRAM THAT I CARE ABOUT?

This is a tricky task. Because of the recurring/non-recurring issue discussed on page 8, the Budget often differentiates between recurring and non-recurring when displaying recommended increases and decreases. While it may make future budgeting a little easier, it makes figuring out what's going on with a particular program's funding from one year to the next challenging. The Budget has several tables that specifically call out "cost increases" and "base budget reductions," but don't be quick to pull numbers from these displays to discuss how a program's funding is changing overall. These Budget exhibits show incremental changes to specific kinds of funding – some recurring, some non-recurring, some from state revenue sources, and some from all revenue sources.

To understand <u>state</u> funding changes for a particular department, for example, you'll have to visit at least three places in the Budget:

- The *Comparison of Programs* table (beginning on page A-17 in the FY 2016-2017 Budget document) shows department-level funding by revenue source – including a column showing how these numbers are changing from the current fiscal year's estimated Budget to the upcoming fiscal year's recommended Budget. This provides context for how state funding fits into the overall picture for the department.
- The *Departmental Comparison of Appropriations from State Revenues, Recurring and Non-Recurring* table (beginning on page A-26) shows the portions of the estimated current year state funding that are recurring and non-recurring. Any non-recurring portion doesn't automatically carryover into the upcoming fiscal year. This table also shows the recommended recurring and non-recurring state funding increases.
- The *Departmental Comparison of Recurring Appropriations from State Revenues* (beginning on page A-24) shows recommended department-level reductions in state funding to the current fiscal year recurring base.

If you add all of the incremental decreases and increases found in The *Departmental Comparison of Appropriations from State Revenues, Recurring and Non-Recurring* and the *Departmental Comparison of Recurring Appropriations from State Revenues* tables to the current fiscal year state funding amount, you should arrive at the state funding budget recommendation for the upcoming fiscal year. Now, let's try it with the FY 2016-2017 Budget:

DEPARTMENT OF HEALTH

$189,253,200 - estimated FY 2015-2016 state funding (pA-20)

Incremental Reductions:
-$12,412,200 - discontinuation of FY 2015-2016 non-recurring state funding (pA-27)
-$2,314,900 - new recommended recurring base budget reduction (pA-25)

Incremental Increases:
+$1,911,100 - new recommended recurring base cost increase (pA-27)
+$19,788,100 - new recommended non-recurring base cost increase (pA-27)

$196,225,300 - recommended FY 2016-2017 state funding

Some additional information about cost increases in federal and other funding is available on the *Departmental Summary of Costs Increases* table (page A-36).

Additional program-level information is found in both the *Program Statement by Functional Area* section (beginning on page B-3) and in "Volume 2: Base Budget Reductions." The former has information on total funding by revenue source along with a delineated display of recommended funding increases. The latter focuses exclusively on budget reductions targeted at the base budget. In some instances, this volume will display changes to federal or other revenues where they might be offsetting a recommended state funding reduction.

HOW CAN I FIND OUT THE BUDGET FOR A PROGRAM IN THE MIDST OF A FISCAL YEAR?

Not surprisingly, many people may have an interest in how funding shook out in the legislative process or where funding stands at some point in the midst of a fiscal year for a particular department or program. Finding out these numbers, however, can be difficult.

As discussed previously, numbers change throughout the fiscal year for a variety of reasons. These evolving mid-year budget numbers that reflect enacted appropriations and any subsequent executive branch spending decisions are often referred to as the "work program." The Budget Division, however, does not publicly publish the work program. Mid-year budget numbers are only published publicly in the State Fact Book, which is usually published in November, and the next fiscal year's Budget, usually published in January. These will provide point-in-time budget estimates – the former at the department level and the latter at both the department and program level. That means you may have to wait a good six months after an appropriations bill is passed and nearly halfway through the fiscal year to see an updated enacted budget number publicly published for a department…and even longer for a program.

If you're not willing to wait that long to understand how the General Assembly acted on the Governor's Budget, you can use the enacted appropriations bill to get an idea of how a department or program faired. The appropriations bill includes information at both the department and program level, but because the bill often includes lump sum appropriations under "Miscellaneous Appropriations" for items that are later divvied up among the departments (e.g. funding to cover the increased costs of state employee health insurance), you won't be able to arrive at a final enacted number.

To get in the neighborhood, you can either comb through the bill item by item, or open the appropriations bill on the General Assembly's website and search for key terms and department names. Provisions with words like "in addition to" or "reduced by" indicate incremental changes to the recommended Budget amounts; while provisions with words like "from" generally earmark funds within the recommended amount for specific purposes. To continue the example above,

we searched for "Health" in the FY 2016-2017 appropriations act to find the following changes to the Governor's recommendation above:

DEPARTMENT OF HEALTH

$196,225,300 - recommended FY 2016-2017 state funding

Incremental Reductions:

-$2,000,000 - non-recurring reduction for Governor's Health and Wellness Foundation (p94)
-$527,000 - recurring reductions related to SB 320/HB 289 (p94)

Incremental Increases:

+$50,000 - recurring funds for Controlled Substances Monitoring Database legislation (p90)
+$250,000 - non-recurring funds for Controlled Substances Monitoring Database legislation (p90)
+$32,000 - non-recurring funds for the National Coalition of 100 Black Women grants (p97)
+$47,000 - non-recurring funds for Epilepsy Foundation grants (p97)
+$95,000 - non-recurring funds for Health Awareness Promotion Among Males grant (p97)
+$500,000 - recurring funds for nurse educator grants (p96)
+$3,200,000 - non-recurring funds for health center capacity grants (p98)
+$750,000 - Smile 180 Foundation dental service grants (p99)

Overall, this means that the General Assembly enacted a budget for the Department of Health that was about $2.4 million more than was recommended by the Governor in the Budget document.

Year-end Budget numbers, which include the over-appropriation and underfunding issues discussed on page 11, are never publicly published. Final actual expenditures numbers at both the department and program levels are made available in the Budget that is published about seven months after the end of the fiscal year.

WHY DO SOME DOCUMENTS REPORT THE OVERALL BUDGET NUMBER DIFFERENTLY THAN OTHERS?

There are about a million ways to slice and dice a state budget. For example, it may make sense in some contexts to discuss the state Budget only in terms of state dollars. For other purposes, it may make sense – or some may prefer – to exclude certain kinds of revenues and/or spending like tuition and fees for state colleges or revenues from the lottery.

WHY DO APPROPRIATIONS BILLS INCLUDE TWO FISCAL YEARS?

An appropriations bill usually includes not only appropriations for the upcoming fiscal year but also some changes to the current fiscal year in which the bill is passed. These are often small modifications and supplements that might be needed, for example, to allow the administration to spend unexpected revenue from federal grants. (See page 11.)

PARTING WORDS

The Budget is a financial representation of Tennessee's goals as a state. It reflects our detailed plan for achieving those goals and calculates how we are going to pay for what we need.

Policymakers are charged with making sound, sustainable decisions for the long-term health and well-being of our state: investing in high quality education for our children, meeting the infrastructure needs of our businesses, and providing health care and other supports to families striving for a better life.

Tennessee's constitutional requirement to deliver a balanced budget every year reflects the state's commitment to conservative fiscal management, but it also delivers some challenging constraints for policymakers. The dynamic nature of the budgeting process, the relatively few budget decisions within the discretion of the General Assembly, and the numerous other limitations attached to so many revenue sources only increase the level of difficulty of the task.

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**Pages 30 and 34 of this document were updated on October 30, 2017. The graph on page 30 was updated to correct a typo in the FY 1994-1995 data label. Page 34 was updated to remove inconsistently-applied inflationary updates for the state spending and personal income metrics.*

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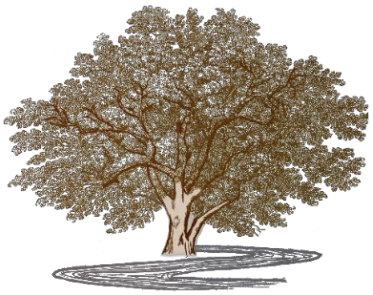
Launched in 2015, The Sycamore Institute is an independent, nonpartisan public policy center for Tennessee. The Institute's mission is to provide accessible, reliable data and research in pursuit of sound, sustainable policies that improve the lives of all Tennesseans.

SUGGESTED CITATION:

The Sycamore Institute, "Tennessee State Budget Primer: A Foundation for Understanding Our State's Public Policies," 2016.



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