INTERIM

REPORT ON

BUDGET REFORM

Prepared by:

Joint Task Force on Budget Reform

May 2017

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INTERIM REPORT

FROM THE

JOINT TASK FORCE ON BUDGET REFORM

WHY WAS THE JTF CREATED?

Year after year, session after session, the Alabama Legislature returns to Montgomery to answer the same, age-old question: “What are we going to do to fill the hole in the General Fund Budget?” Certainly, there have been times over the years that this was not the case, but for the most part this question has been asked annually for decades.

Faced with tremendous growth in Medicaid, less than adequate funding in essential functions of government, and the frustration of yet another approaching session to answer “the question”, the Legislature passed a joint resolution in September of 2016 that created The Joint Task Force on Budget Reform (JTF). The members of the JTF are as follows:

House	**Senate**
Representative Danny Garrett (Co-Chair)	Senator Clyde Chambliss (Co-Chair)
Representative Anthony Daniels	Senator Greg Albritton
Representative Allen Farley	Senator Linda Coleman-Madison
Representative John Knight	Senator Bill Hightower
Representative Chris Pringle	Senator Bill Holtzclaw
Representative Kyle South	Senator Bobby Singleton
Representative Rich Wingo	Senator Phil Williams

The JTF was created “to examine the structure and design of the state budgeting process and make recommendations for long-term budget and tax system reforms. The task force shall evaluate and recommend changes to state budgeting practices including, but not limited to” the following five categories:

1) BUDGET PROCESS – how can the overall budget process be improved
2) AGENCY REVIEW – what can be done to improve transparency and accountability of state agencies
3) EARMARKING – what steps should be implemented so that revenues can be better appropriated based upon needs
4) TAX CREDITS, EXEMPTIONS, DEDUCTIONS – what steps should be taken to ensure that tax preferences are beneficial to the state and its citizens
5) TAX FAIRNESS – what measures should be implemented to reduce the tax burden on middle and lower class citizens and improve the fairness of tax policy

WHAT HAS THE JTF BEEN DOING?

From the beginning, it was apparent that any discussion, and ultimately any solution must be an effort of both the legislative and executive branches of government. Reforms made by one but resisted by the other would prove unworkable. This was evidenced at the first meeting of the JTF in which Speaker Mac McCutcheon, Pro-Tem Del Marsh, and Governor Bentley attended and committed their full support and encouragement to the JTF. Each of the three leaders have continued this support throughout the process, lending staff and resources to the effort. Governor Ivey attended and participated in several of the meetings of the JTF as Lt. Governor and continues to support the work of the JTF. Governor Ivey stated that she "is eager to participate in the discussion and formulation of solutions in our quest to Steady the Ship of State. I will continue to work with the Joint Task Force and pledge the coordination and assistance of my office to accomplish this all-important task."

Given this direction for working with both legislative and executive branches, JTF co-chairs met early and often with executive branch leaders and agencies. Presentations from the executive branch were presented to the entire JTF by:

1) Finance Department, Clinton Carter, Director of Finance
2) Revenue Department, Michael Gamble
3) Revenue Department, Joe Garrett, Deputy Commissioner
4) State Auditor, Jim Zeigler
5) State Treasurer, Young Boozer

Current and former Legislative Budget Chairs have a wealth of information and were also asked to make presentations:

1) Senator Arthur Orr, Senate Finance and Taxation Education Trust Fund Chair
2) Senator Trip Pittman, Senate Finance and Taxation General Fund Chair
3) Representative Steve Clouse, House Ways and Means General Fund Chair
4) Representative Bill Poole, House Ways and Means Education Trust Fund Chair
5) Representative John Knight, previous House Ways and Means General Fund Chair

The JTF also looked outside the state for assistance and presentations were made by the following:

1) Jonathan Williams, Vice President, American Legislative Exchange Council
2) Eric Schnurer, President, Public Works, LLC

The JTF was tasked to present a report to the Legislature on the 5th Legislative Day of the 2017 Regular Session. Due to the size of the task at hand, Study Groups were formed to research, evaluate, and ultimately make recommendations. As the study progressed, it became evident that the short time line between October of 2016 and the beginning of the Session in February of 2017 was not enough time to properly research, evaluate, develop and vet a comprehensive solution to our state's fiscal woes.

Therefore, the JTF submitted an Initial Report in which it was requested that the work of the JTF continue until the beginning of the 2018 Regular Session. The legislature agreed and adopted SJR which extended the work of the JTF and required this Interim Report to be submitted before the end of the 2017 Regular Session. This Interim Report is not the end of the work, but actually the beginning. Much work remains, but this report is a beginning of the information and recommendations of the JTF. This Interim Report answers the questions a) Why were we formed? b) What have we been doing? and c) What is the problem?

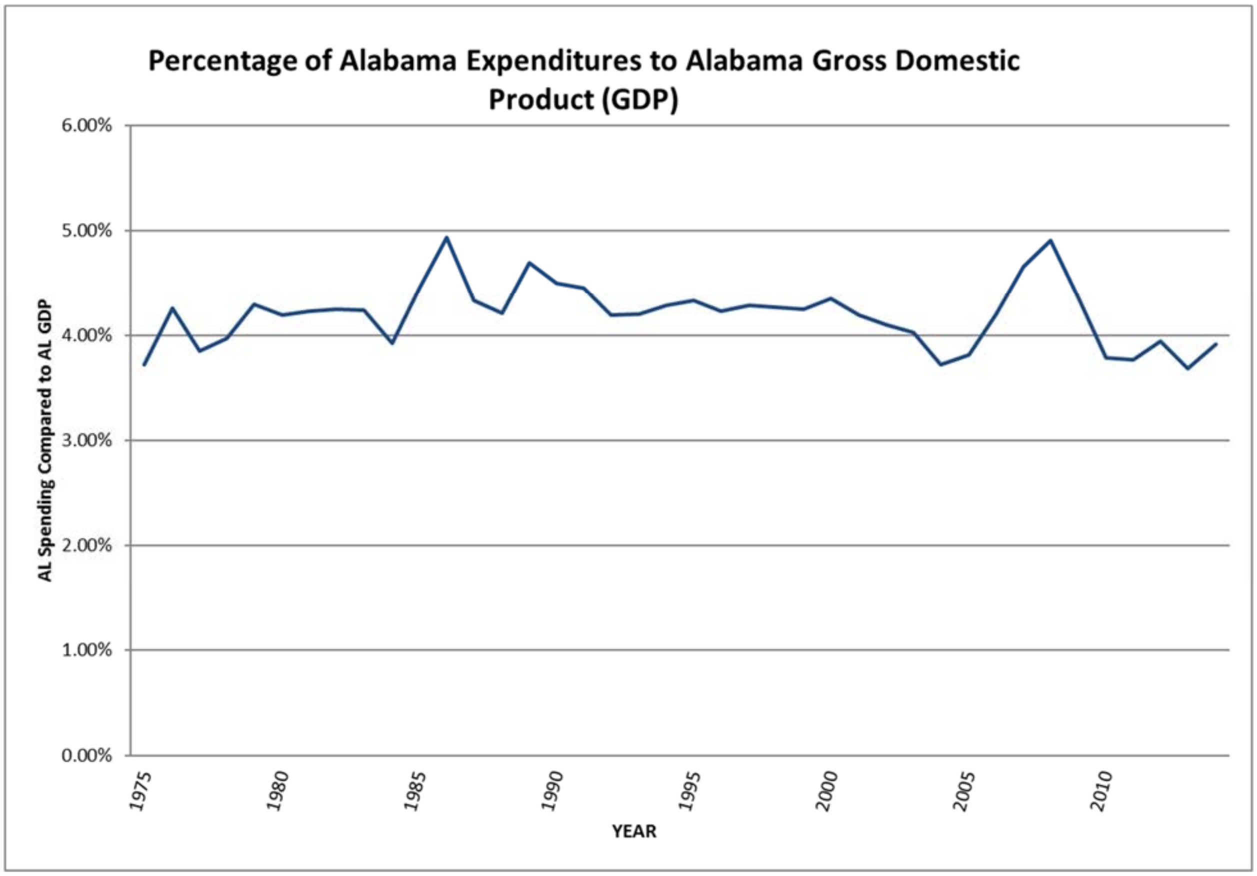
It is anticipated that between the end of the 2017 Regular Session and the beginning of the 2018 Regular Session a comprehensive plan to solve the fiscal woes of our state can be developed, vetted, and proposed for implementation.

Although time has not allowed for full development of the comprehensive solution, there are several recommendations that the JTF feels are timely. These Initial Recommendations are outlined herein for each of the five areas of study. These Initial Recommendations are not to be taken as the final work, merely things that have been identified through our initial work that should be implemented sooner rather than later.

WHAT IS THE PROBLEM?

There are a multitude of opinions regarding the fiscal problem in the State of Alabama. These opinions are formulated by background, experience, level of knowledge and many other factors of each individual. This section will attempt to outline the problem from a fact-based perspective. Certainly, to arrive at a comprehensive solution, we must know the good and the bad of where we are currently, and where we want to go. Only after agreement of these positions can we formulate a path to get from current reality to future prosperity.

A common thought is that state government in Alabama is too big, has grown too fast, and wastes too much money. To determine the facts of this situation, one can look at other states of similar size and compare Alabama to them, but if the other states are bloated then the comparison is meaningless. So, a comparison was made of expenditures of state government in Alabama to Gross Domestic Product in Alabama for the last 40 years.



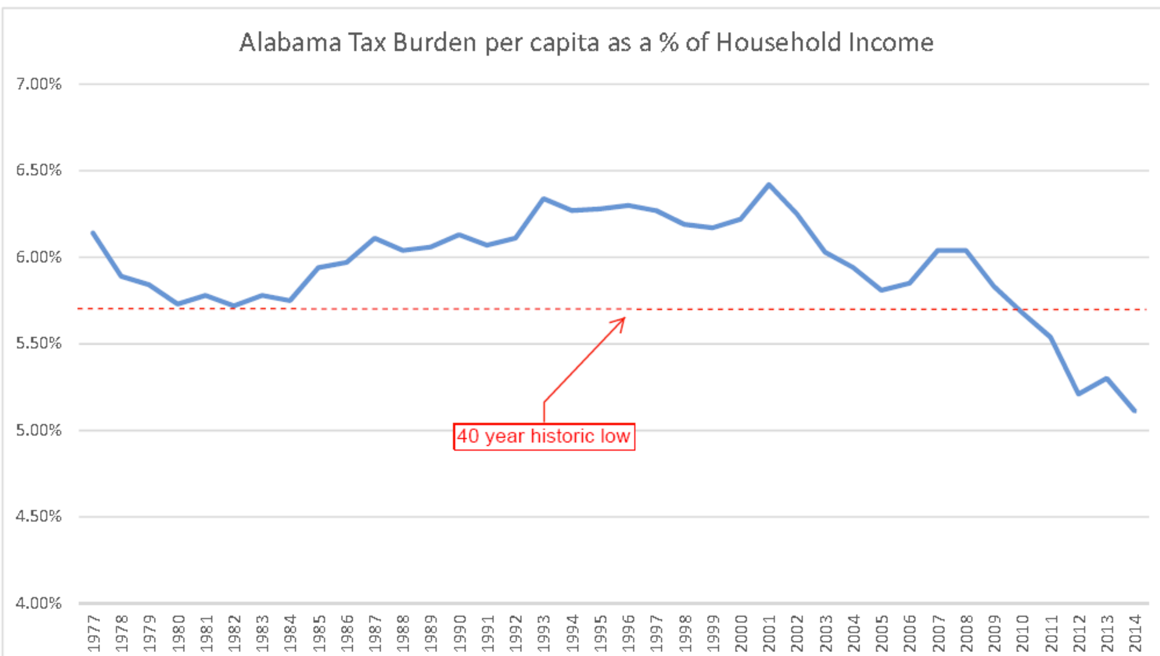
What was found was actually surprising to the JTF. State government has actually grown at roughly the same rate as the private sector over the last 40 years. Including a few peaks in very prosperous years, spending by state government has averaged 4.2% of Alabama GDP.

This method of analysis includes the effects of inflation on the business as well as the government side of the equation; therefore, adjustments are not needed since they would simply cancel each other out.

From discussion among the JTF, this was not the Legislative perception and certainly not the public perception. A simple explanation could be that we see so much media regarding our bloated federal government, that we apply that same thought and logic to state government. As shown in the previous chart, this perception is simply not accurate.

This is not to say that the JTF does not think that there is waste and inefficiencies in state government, but these are more a function of the size of the entity than the type of the entity. Most that have experience in large private entities will report the same waste and inefficiencies. Public focus is not on the private entities, but state government deals with public dollars and it is incumbent upon those that serve to spend those dollars in the most efficient and effective way possible. That is our duty.

A second common perception is that we pay too much in taxes. Once again, using data from the last 40 plus years the following chart shows the Alabama Tax burden per capita as a percentage of Household Income.



Source: Bureau of Economic Analysis

As shown in the chart, Alabama's average has been fairly consistent averaging around 6% from the mid 70's to the mid 2000's. However, since 2008 the state tax burden has decreased to nearly 5%, well below the 40-year low.

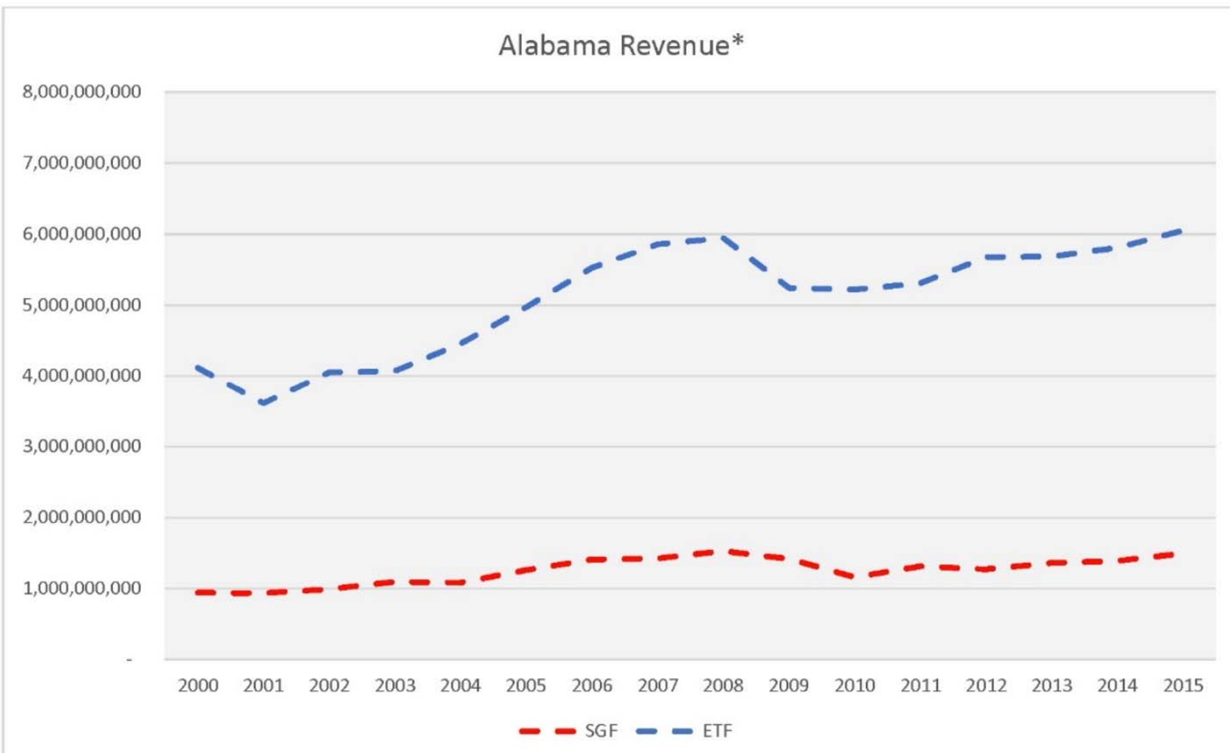
This decreasing tax burden per capita, coupled with the similar growth of state government compared to the private sector, show that state government in Alabama is responding to public sentiment to become more efficient and effective while also providing the services expected.

This begs the question: So why do we have budget shortfalls seemingly every year when the Legislature returns to Montgomery? To answer this question, we must have a detailed understanding of state finances.

Alabama is one of only three states that have two operating budgets. Funds used for educational purposes are separated from all other funds. These funds make up the Education Trust Fund (ETF). All other funds are appropriated through the State General Fund (SGF). The funds for Education are distributed to the Education Trust Fund by state statute or the state Constitution. For a detailed explanation of the Alabama Budgets, see the Legislative Fiscal Office presentation located on the LFO website and entitled State Budget Process – Task Force. The report can be access directly via the following web address:

http://lfo.state.al.us/PDFs/Presentations/STATE_BUDGET_PROCESS-Task_Force_9.28.16.pdf

It is commonly discussed that the SGF is approximately $1.8 billion and the ETF is approximately $6 billion as shown in the chart below.



*For the purposes of this discussion, this chart and the two that follow show Revenue instead of Appropriations. This is different from what is normally discussed. What is normally discussed are "the budgets" (appropriations). As the JTF studied the budgeting process it became apparent that it is critical that we must distinguish between revenue and budgeted funds.

This is required because there are transfers from state agency to state agency that are "double counted" in the budgeting process. This is different from a private business operating multiple divisions because the Constitution requires that monies spent by an agency be appropriated to that agency before they can be spent.

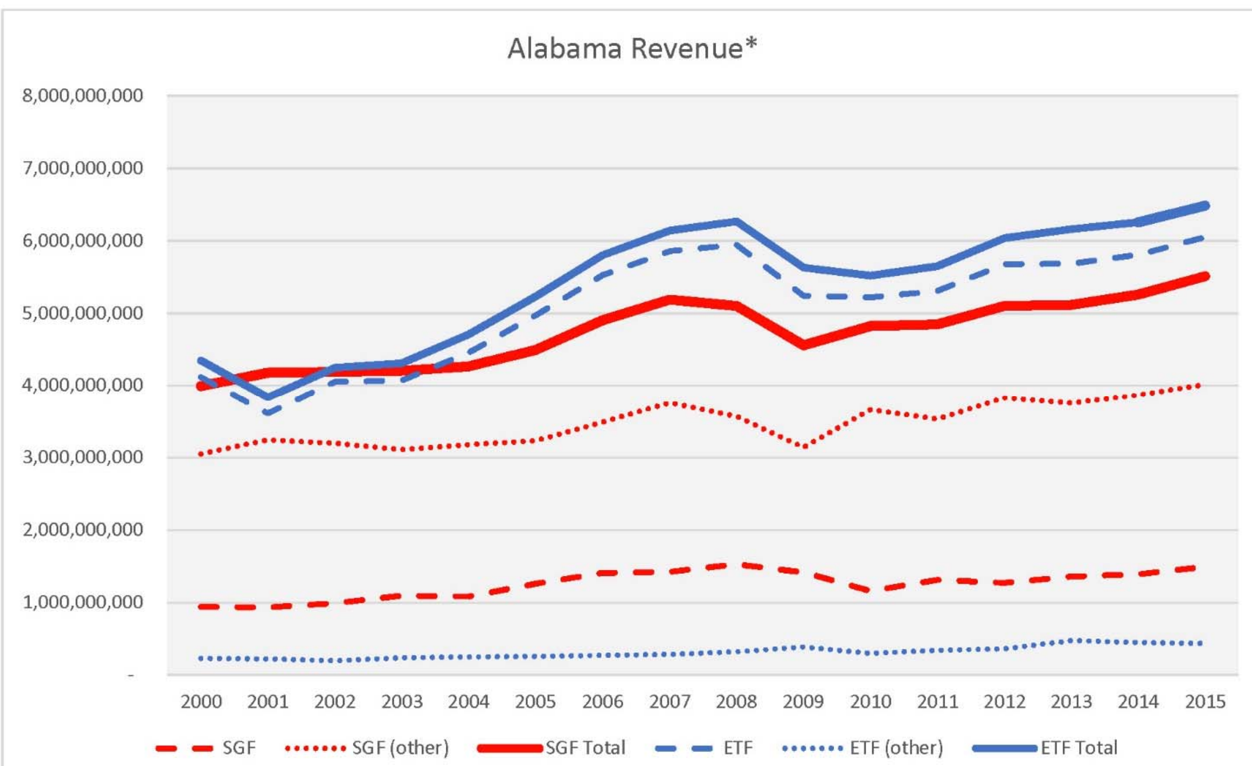
An example of this is that an agency may be appropriated money that is to be used for rent and utilities for their office space and it happens that this agency is housed in a state-owned facility that is managed by the Department of Finance. Rent is paid by the Agency to the Department of Finance.

The Department of Finance is not able to spend the money on the facility for maintenance, repair, utilities, etc. unless the legislature appropriates the money for them to spend. Therefore, this same money is appropriated for both agencies.

Thus, the confusion: if you add all state appropriations together, you get a sum of approximately $30 billion. However, if you add all revenues you net a sum of around $22 billion. Double counted appropriations, appropriations that exceed revenue, and several other similar anomalies account for this difference. Making decisions based on the sum of both budgets must be avoided because of these differences. The decision-making process must be based on sound financial principles and it is encouraged that the JTF studies this issue in more detail before preparing its Final Report in the 2018 Regular Session.

A second category of funds that must be accounted for are federal funds. The state receives approximately $9 billion in federal funds per year. These funds have been subtracted from the totals in the charts as well so that <u>Alabama Revenue</u> is used to determine growth rates, trends, and the future path of spending in the two funds.

The previous chart is an accurate depiction of <u>portions</u> of the two respective funds. However, to get a complete picture of state revenue, one must consider all (Alabama Revenue) portions of each fund.

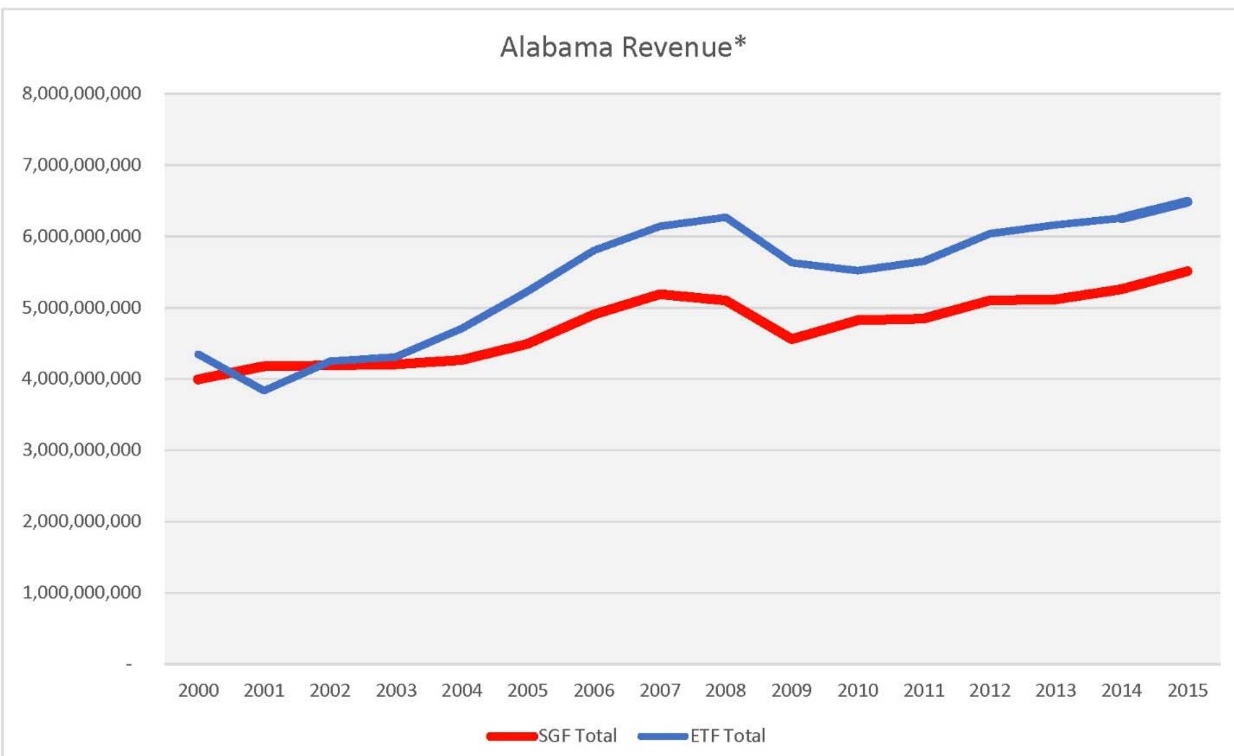


The red lines depict the two components of the SGF as well as the Total SGF. Likewise, the blue lines depict the two components and the Total ETF.

As can be seen, the total SGF is actually much closer to the same size of the total ETF than is typically discussed. Notice the "SGF (other)" line in the chart. These are the funds that are earmarked to go directly to a specific purpose or entity. Alabama ranks the highest in the nation with approximately 93% of our total revenue earmarked. Putting this into a personal perspective, imagine that you only had discretion over 7% of your personal income – this is the situation that the Legislature faces each year when trying to balance the budget.

The chart below shows only the SGF Total and the ETF Total. As can be seen from the chart, the SGF and the ETF were approximately the same size in the early 2000's. However, from 2003 to 2008, the growth in the ETF greatly outpaced the SGF. This is primarily due to the fact that during economic expansion, the funds that are earmarked to the ETF grow faster than those that make up the SGF.

Notice however, that from 2012 to the present, the rate of growth in the two funds is fairly even. This is likely due to two things: 1) the growth in the economy has been slow and 2) adjustments made by the Legislature to where certain funds are appropriated have "balanced" the growth in the two funds. Time will tell if it is the former, the latter, or a combination of the two.



The work of the JTF over the summer of 2017 and leading up to the Regular Session of 2018 will be to focus on the revenue and expenditures of the SGF and form a basis for determining priorities for spending going forward.

To appropriately determine, assess and appropriate the annual State General Fund (SGF) and Education Trust Fund (ETF) Budgets of the state of Alabama, the stakeholders– the taxpayers and the executive and legislative branches of government need to clearly define:

- The **ROLE** of state government
- The **ESSENTIAL SERVICES** of state government
- The **SPENDING PRIORITIES** of state government

At present, there is no collective understanding or agreement of these items by the stakeholders. The current "incremental budgeting" approach considering last year's appropriations plus or minus an incremental amount does not provide a clear picture of the actual spending by state agencies. The legislature does not have in-depth access or knowledge of the total funds received -- from all sources -- by state agencies.

Also, more than 90% of the funds appropriated in the two state budgets are earmarked. (To compare, the average among the other 49 states is approximately 30%). Alabama earmarks more funds than any state. Approximately 50% of earmarks are statutory and can be modified through passage of legislation. About 50% of the earmarks are constitutional and can only be modified by a statewide vote of the citizens. In addition, most of the funding sources (i.e., taxes, fees, etc.) that are earmarked to the ETF are "growth revenue", meaning that the amount available increases over time. To the contrary, most of the funding sources that feed the GF are comprised of flat or declining revenue sources.

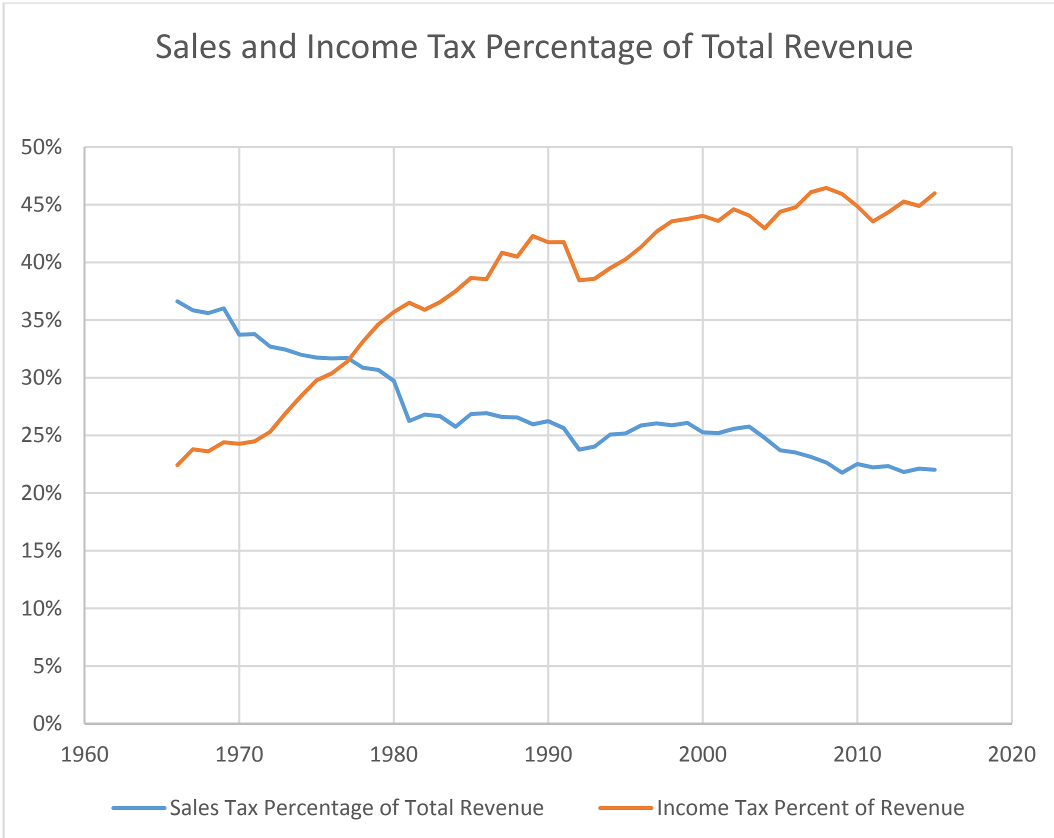
Each year, the state allows taxpayers to take advantage of approximately $4.5 billion of tax credits, exemptions, deductions, and preferential tax rates. Many of these tax benefits were established decades ago and have not been reviewed or modified since inception. In addition, some items were granted under the premise that the benefit would result in economic development and/or increased revenue for the state. The Legislature is at the beginning stages of evaluating the ongoing effectiveness of these tax benefits and to determine if the tax preferences are beneficial to the state's revenue.

Finally, Alabama's basic tax structure has not been modified or updated for decades, primarily because of limitations imposed by the state Constitution. Although the breadth of Alabama's tax structure is wide, the state is heavily dependent upon sales taxes, which are extremely volatile. In addition, many of Alabama's surrounding states have fewer and lower taxes that rely upon more stable and predictable sources of revenue. Alabama's tax structure is generally not as attractive or competitive as neighboring/competing states.

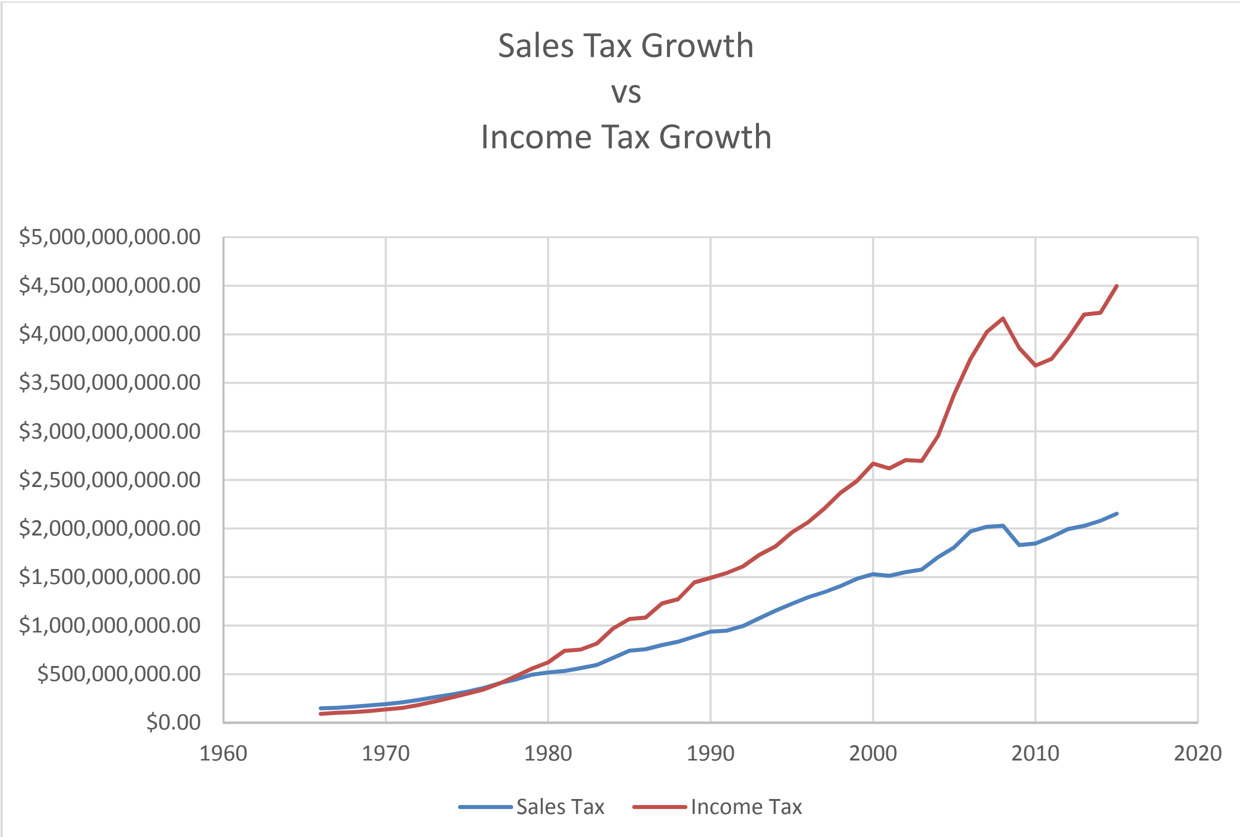
Perhaps the most telling of all the issues that contribute to the state's fiscal problems is the erosion of the tax base.

State sales tax revenue as a percentage of total revenue has been on the decline. In the1960s sales tax revenue collections represented 37% of the total revenue collected. Currently, sales tax revenue collections represent 22% of the total revenue collected.

Income tax revenue as a percentage of total revenue has increased. In the 1960s income tax revenue collections represented 22% of the total revenue collected. Currently, income tax revenue collections represent 46% of the total revenue collected.

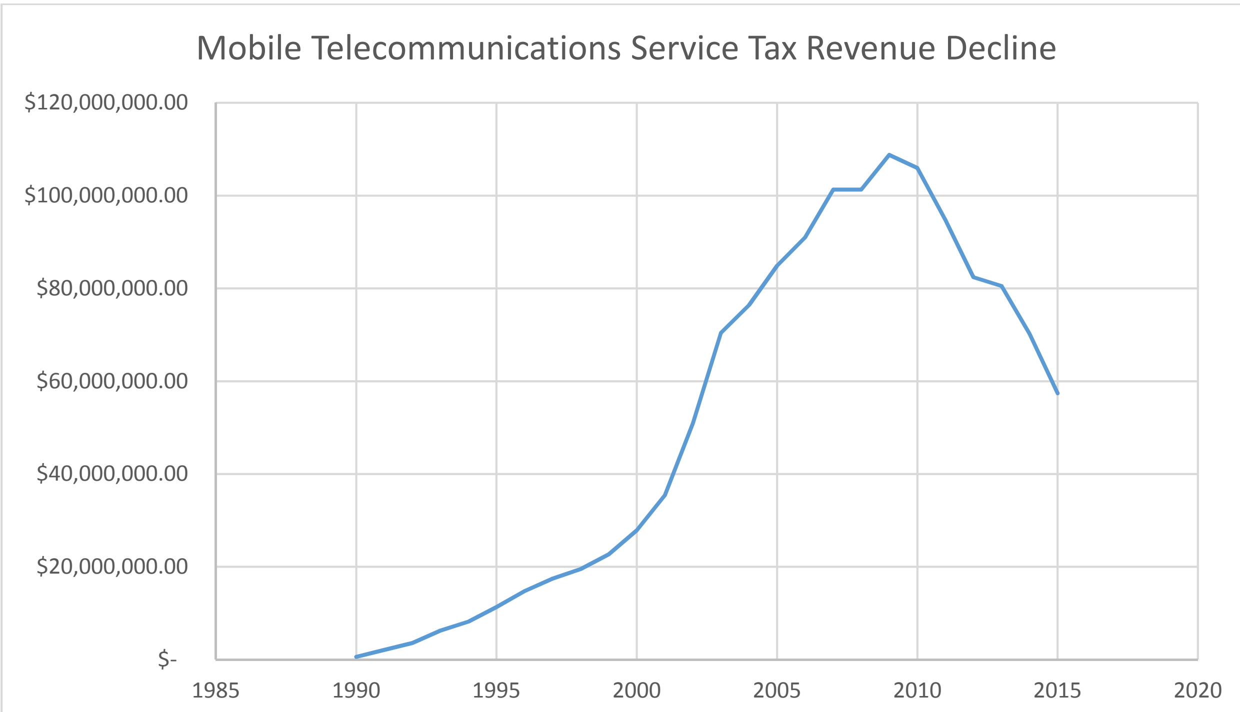


Both sales tax and income tax have seen growth from the 1960s until now. However, income tax has seen a more rapid growth pace. Sales tax has seen an average growth rate of 6% from the 1960s until now. Income tax has seen an average growth rate of 8% from the 1960s until now.



Stated in different words, in the 1960's approximately two-thirds of our economy was taxed. Now approximately one-third of our economy is subject to state taxation. This shift in our tax base is problematic for adequate, or even level funding of government.

Additionally, even more modern taxes have seen significant swings due to the changes in our society. Mobile telecommunications tax has been declining since 2009. The mobile telecommunications tax peaked in 2009 with revenue of $108,783,708. In 2015, mobile telecommunications tax revenues had fallen to $57,384,461.



Other examples of revenues with significant declines are interest revenue, oil and gas royalties, inheritance tax, and court costs.

This shifting of tax base further highlights the need for prioritizing of expenditures by the Legislature and the Executive branches of the State of Alabama.

JTF REPORT ON DEBT

The ability of the State of Alabama to incur debt is limited by Constitution and statute. The State participates in the issuance of two types of Bond Debt:

- General Obligation Bonds; and
- Revenue Bonds

General Obligation Bonds are backed by the full faith and credit of the State and are repaid from taxes and other general revenue sources. A Constitutional Amendment is required for General Obligation Bond issues. In recent years, General Obligation Bonds have primarily been used for economic development purposes. As of September 30, 2016, the total amount of General Obligation Bonds outstanding was $646,315,000.

Revenue Bonds refer to bonds for which principal and interest payments are pledged from specific tax revenues and (or) from revenues from the operation of a public enterprise such as the State Port facility, building rental charges, and the State Farmer's Market user charges. These bonds are issued by public corporations that are established by Acts of the Alabama Legislature. Bonds issued by these public corporations are obligations of the corporations that are held to be separate and distinct entities from the State; therefore, these obligations do not legally constitute debts of the State. In most instances, state officials such as the Governor, Lieutenant Governor, Attorney General, State Treasurer and department heads of the benefiting departments serve as members of these corporations. As of September 30, 2016, the total amount of Revenue Bonds outstanding was $4,060,725,000.

Because of the strict legal limitations on State's ability to issue debt, combined with a general policy and practice of conservative financial management, the State has not issued debt for ongoing operational costs. Rather, debt issues have been generally limited to capital projects such as buildings, roads and bridges.

The Alabama Trust Fund is an account that was initially created in the 1980's that was funded from revenue derived from the sale of the State's right to extract oil and natural gas from the Gulf of Mexico. As of December 31, 2016, the Alabama Trust Fund had a balance of approximately $3.0 billion.

Upon creation of the Alabama Trust Fund, two Constitutional Amendments were passed which established the Education Trust Fund Rainy Day Account and the General Fund Rainy Day Account. From time to time, withdrawals have been made from each Rainy Day Account to shore up shortfalls in the Education Trust Fund and the General Fund. Withdrawals from the ETF Rainy Day Account are limited to 6.5% of the previous years' budget and must be repaid over a period of 6 years. Withdrawals from the General Fund Rainy Account are limited to 10% of the prior years' budget and must be repaid over 10 years. As of today, both Rainy Day Accounts have been fully repaid.

In 2012, as a result of a dire shortfall in the General Fund, a Constitutional Amendment was passed which allowed for a 3 year transfer of $437 million from the Alabama Trust Fund to the GF. (The Constitutional Amendment did not require the repayment of the transfer to the Alabama Trust Fund). In 2013, the Legislature passed a statute requiring repayment to the Alabama Trust Fund withdrawals beginning in 2014 and continuing through 2026. To date, approximately $253 million has been repaid to the Alabama Trust Fund, leaving $184 million outstanding. Funds from the BP Settlement were used to satisfy payments due through 2019. In 2020, the General Fund must resume repayments to the Alabama Trust Fund at a rate of $13 million per year, with the final payment in 2033.

Attached are schedules showing:

- Historical Principal Balances outstanding for General Obligation Bonds
- Historical Principal Balances outstanding for Revenue Bonds
- Scheduled Principal and Interest Due Dates for General Obligation Bonds
- Scheduled Principal and Interest Due Dates for Revenue Bonds
- Scheduled Principal and Interest Due Dates for Total Bonds

General Obligation Bonds

(Principle Outstanding)

9/30/2000	$292,481,506.00
9/30/2001	$433,057,873.00
9/30/2002	$533,106,092.00
9/30/2003	$488,213,291.00
9/30/2004	$443,440,382.00
9/30/2005	$500,591,280.00
9/30/2006	$509,339,472.00
9/30/2007	$756,704,000.00
9/30/2008	$705,480,000.00
9/30/2009	$672,555,000.00
9/30/2010	$741,250,000.00
9/30/2011	$715,860,000.00
9/30/2012	$683,715,000.00
9/30/2013	$660,195,000.00
9/30/2014	$610,825,000.00
9/30/2015	$571,645,000.00
9/30/2016	$646,315,000.00

Alabama Revenue Bonds

(principal amount outstanding)

FY 2000	1,835,535,584
FY 2001	1,857,315,896
FY 2002	2,269,818,043
FY 2003	2,209,922,181
FY 2004	2,211,195,027
FY 2005	2,206,754,180
FY 2006	2,124,413,170
FY 2007	1,988,602,589
FY 2008	2,979,225,000
FY 2009	2,831,170,000
FY 2010	3,040,462,000
FY 2011	3,053,087,000
FY 2012	2,899,297,000
FY 2013	3,356,157,000
FY 2014	3,218,652,000
FY 2015	3,602,037,000
FY 2016	3,370,042,000

Excludes Proprietary Funds

STATE OF ALABAMA BONDED INDEBTEDNESS

EXCLUDING REFUNDED BONDS

GENERAL OBLIGATION BONDS BY DUE DATE

Fiscal Year	Annual Interest Payments	Annual Principal Payments	Total Annual Payments
2016-2017	29,191,228	41,800,000	70,991,228
2017-2018	27,006,459	52,410,000	79,416,459
2018-2019	24,563,384	54,940,000	79,503,384
2019-2020	21,884,209	57,665,000	79,549,209
2020-2021	19,101,909	60,740,000	79,841,909
2021-2022	16,192,259	49,625,000	65,817,259
2022-2023	13,910,159	42,440,000	56,350,159
2023-2024	11,873,159	44,325,000	56,198,159
2024-2025	9,872,359	46,240,000	56,112,359
2025-2026	7,584,071	38,215,000	45,799,071
2026-2027	6,182,396	36,610,000	42,792,396
2027-2028	4,391,546	15,400,000	19,791,546
2028-2029	3,691,096	16,040,000	19,731,096
2029-2030	2,961,296	16,720,000	19,681,296
2030-2031	2,440,109	17,195,000	19,635,109
2031-2032	1,744,640	17,845,000	19,589,640
2032-2033	1,108,390	9,020,000	10,128,390
2033-2034	768,300	6,950,000	7,718,300
2034-2035	556,650	7,160,000	7,716,650
2035-2036	338,625	7,375,000	7,713,625
2036-2037	114,000	7,600,000	7,714,000
Total	205,476,244	646,315,000	851,791,244

REVENUE OBLIGATION BONDS BY DUE DATE

Fiscal Year	Annual Interest Payments	Annual Principal Payments	Total Annual Payments
2016-2017	165,803,130	269,215,488	435,018,618
2017-2018	163,166,355	300,060,488	463,226,843
2018-2019	150,115,903	317,665,488	467,781,391
2019-2020	136,263,940	249,660,488	385,924,428
2020-2021	125,782,841	259,155,488	384,938,329
2021-2022	115,088,336	226,650,488	341,738,824
2022-2023	105,747,246	224,655,488	330,402,734
2023-2024	96,478,570	217,280,488	313,759,058
2024-2025	87,568,418	209,030,488	296,598,906
2025-2026	76,821,287	211,230,488	288,051,775
2026-2027	66,825,309	207,125,317	273,950,626
2027-2028	57,337,218	181,120,000	238,457,218
2028-2029	52,074,770	116,400,000	168,474,770
2029-2030	46,842,259	132,460,000	179,302,259
2030-2031	41,879,469	135,965,000	177,844,469
2031-2032	35,660,247	142,570,000	178,230,247
2032-2033	29,667,194	117,875,000	147,542,194
2033-2034	24,686,875	98,195,000	122,881,875
2034-2035	20,516,488	171,390,000	191,906,488
2035-2036	12,710,263	175,555,000	188,265,263
2036-2037	4,708,625	13,120,000	17,828,625
2037-2038	4,127,875	13,705,000	17,832,875
2038-2039	3,486,500	14,345,000	17,831,500
2039-2040	2,814,750	15,015,000	17,829,750
2040-2041	2,064,000	15,770,000	17,834,000
2041-2042	1,275,500	16,550,000	17,825,500
2042-2043	448,000	4,370,000	4,818,000
2043-2044	229,500	4,590,000	4,819,500
Total	1,630,190,868	4,060,725,197	5,690,916,065

TOTAL BONDED INDEBTEDNESS BY DUE DATE

Fiscal Year	Annual Interest Payments	Annual Principal Payments	Total Annual Payments
2016-2017	194,994,358	311,015,488	506,009,846
2017-2018	190,172,814	352,470,488	542,643,302
2018-2019	174,679,287	372,605,488	547,284,775
2019-2020	158,148,149	307,325,488	465,473,637
2020-2021	144,884,750	319,895,488	464,780,238
2021-2022	131,280,595	276,275,488	407,556,083
2022-2023	119,657,405	267,095,488	386,752,893
2023-2024	108,351,729	261,605,488	369,957,217
2024-2025	97,440,777	255,270,488	352,711,265
2025-2026	84,405,358	249,445,488	333,850,846
2026-2027	73,007,705	243,735,317	316,743,022
2027-2028	61,728,764	196,520,000	258,248,764
2028-2029	55,765,866	132,440,000	188,205,866
2029-2030	49,803,555	149,180,000	198,983,555
2030-2031	44,319,578	153,160,000	197,479,578
2031-2032	37,404,887	160,415,000	197,819,887
2032-2033	30,775,584	126,895,000	157,670,584
2033-2034	25,455,175	105,145,000	130,600,175
2034-2035	21,073,138	178,550,000	199,623,138
2035-2036	13,048,888	182,930,000	195,978,888
2036-2037	4,822,625	20,720,000	25,542,625
2037-2038	4,127,875	13,705,000	17,832,875
2038-2039	3,486,500	14,345,000	17,831,500
2039-2040	2,814,750	15,015,000	17,829,750
2040-2041	2,064,000	15,770,000	17,834,000
2041-2042	1,275,500	16,550,000	17,825,500
2042-2043	448,000	4,370,000	4,818,000
2043-2044	229,500	4,590,000	4,819,500
Total	1,835,667,112	4,707,040,197	6,542,707,309

JTF STUDY GROUP REPORT

ON

BUDGET PROCESS

Rep. Kyle South (Chair)

Alabama is one of three states that has more than one state budget. Alabama has two budgets: the Education Trust Fund (ETF) and the State General Fund (SGF). The fiscal year end for the State of Alabama is September 30. By law, the Legislature must annually adopt balanced budgets for both the ETF and the SGF. Both budgets for the next fiscal year are normally completed by the end of the annual Regular Legislative session of the preceding fiscal year (May to June of each year).

The Legislature presently employs an "incremental budget method" when developing annual budgets, meaning that agencies will generally receive "last year's appropriation, plus or minus an incremental amount" based upon perceived spending needs. For fiscal year 2016, the Legislature appropriated $1.8 billion and $6.0 billion, respectively, from the State General Fund and Education Trust Fund, for a total appropriation of $7.8 billion.

Under the current budget process, the spreadsheets the Legislature receives compare the items comprising the $7.8 billion appropriated by the Legislature for the two budgets. However, state agencies actually receive approximately $22 billion in funds annually from several sources. For 2016, in addition to the $7.8 billion legislative appropriations, state agencies received $14 billion from other sources, including the Federal government, earmarked state taxes, various grants, and fees charged by the agencies. **Under the current budget process, the Legislature as a whole has little understanding, details or discussion regarding the items comprising the $14 billion received from other sources.** In addition, the Legislature is not routinely provided with multi-year data, graphs or charts showing the total funds received, by source, for either the ETF or SGF or for each agency.

Also, the Legislature receives little information about "unspent funds" that are carried over from one fiscal year to the next budget year. For 2016, state agencies were re-appropriated $61 million in unspent General Fund appropriations from FY 2015; for 2017, the state agencies were re-appropriated $48.5 million in unspent General Funds from FY 2016. Because the current process focuses on incremental *appropriations* from the prior year, the Legislature generally is not aware of and does not investigate carryover funds.

To improve the budget process, the Study Group recommends that the Legislature should:

- Consider adjusting the budget year to better align with the state fiscal year and the public school calendar

- Work with the Executive branch and citizens to formally define the role of state government

- Work with the Executive branch and citizens to formally identify the essential services that should be provided by state government

- Establish spending priorities based upon the identified essential services of state government. Currently, all appropriations and spending are equally prioritized. Similar to other states, spending priorities should be established on an “A” (highest), “B: and “C” (lowest) priority basis

- Replace the current incremental budget approach with an approach based upon priority spending and identified needs

- The Legislature should consider TOTAL FUNDS RECEIVED by each agency from ALL SOURCES when determining annual amounts to be appropriated to each agency by the Legislature. The Legislature should focus on all funds received by agencies, including funding from the Federal government, fees, grants, etc. in the decision making process.

- Require the Legislative Fiscal Office provide charts and graphs depicting funds received by both the ETF and SGF and each agency for a rolling 15-year period

- Develop a formal process to understand and address unspent appropriations that are carried over from one year to the next. Such process may include an incentive component for efficient agencies that spend less than the amount budgeted.

JTF STUDY GROUP REPORT

ON

AGENCY REVIEW

Sen. Phil Williams, Chair

The Joint Resolution required the Task Force to study procedures and processes that will enable state entities to undergo greater performance and program reviews. For any entity that is long-term in nature like state government, a thorough review of processes, procedures and practices must be made regularly on a periodic basis in order to ensure that things that once were considered necessary continue to be so. Just because something "has always been done" is not a reason that it should continue to be done.

It is likely that state agencies are doing things they are required to do by law, but the original reason for the law is no longer valid. **A policy establishing periodic and ongoing review and elimination of such "no- longer-necessary practices" is prudent and strongly recommended.**

The typical government culture is to spend whatever unspent funds remaining in the budget before, and usually near, the end of a fiscal year, which results in wasteful and inefficient spending. In 2005, in an attempt to curb these wasteful and inefficient practices, the Legislature began allowing, agencies to carryover unspent funds from one year to the next on a limited basis. As unspent appropriations accrued, the Legislature has often used these reserves to balance the budget. The end result of these actions has been a simple shift from "end of year spending", to "carryover spending" without proper controls or justification. Committing to excessive recurring spending in one year with carryover funds can be disastrous in subsequent years when that one-time funding is no longer available.

A significant amount of work was completed by this Study Group to gather information related to Federal dollars received and also fund balances (from Federal, state and other sources) carried over from one year to the next for each state agency. The result of this work is a large three-ring binder that was dubbed "Big Bertha". **This valuable information must not be placed on a shelf simply to gather dust.**

Accordingly, it is the recommendation of this Study Group to require that annually, no later than the first day of each Legislative Session, each agency must submit the following information to the Legislative Fiscal Office:

- Federal dollars received by each agency
- Detail of fund balances carried over by each agency
- A detailed plan for use of carryover funds

It is further recommended that a standing committee be established to review all proposed carryovers of funds by an agency. It also recommended that, to the extent possible, carryover dollars should only be used for capital items and not for operational expenses because they are “one-time” in nature and should not be depended on for long-term expenses. (*Note: Federal rules, regulations and laws dictate how Federal funds may be expended)*

JTF STUDY GROUP REPORT

ON

UNEARMARKING

Rep. Allen Farley, Chair

More than 90% of the revenue collected from Alabama taxpayers is earmarked, well above the 30% earmarking average of other states. About 50% of the state's budget earmarks are statutory and 50% are constitutional. However, before further addressing Alabama's high earmarking percentage, it is important to understand some details behind the calculation of the 90% earmarking figure for Alabama.

Revenue from income taxes, sales taxes, ad valorem taxes, and other sources. are "earmarked" by statute or Constitution to the The Education Trust Fund (ETF). Since these revenue sources constitute the largest percent of funds generated by taxpayers, the earmarking of these funds to the ETF skews the overall earmarking percentage upward. However, once these funds are deposited into the ETF, they are generally available to be appropriated at will (with some exceptions) within the ETF. Without regard to the impact of the huge earmark to the ETF, however, Alabama's earmarking percentage is still higher than most states. A true, "apples to apples" earmark figure for Alabama would be approximately 62% -- still well above the average for other states.

The Study Group determined that Alabama's high earmarking policies are at least partially a result of the taxpayer citizens low trust of the Legislature. Most taxpayers in Alabama likely agree that the practice of earmarking budget dollars is a problem for state budgets. However, in November 2016, approximately 72% of statewide voters supported a Constitutional Amendment to earmark money for state parks.

Working with the Legislative Fiscal Office, the Study Group gathered data and information in order to compare Alabama and other states and assess the impact of earmarking upon a state's "Quality of Life". Quality of Life was evaluated based upon the follow criteria:

- Poverty Rate (*Ranked by Household Income*)
- Unemployment (*As a percentage of state workforce*)
- Public School Systems (*Rank and Annual Budget*)
- Public Safety (*Ranked per number of violent crimes and prison population*)
- Public Health Assessment of State's Residents
- Access to Mental Health Services

The Study Group's comparisons considered population, annual budgets, similar rankings of the above criteria, and other measures. Not surprisingly, the state of Alabama compared *unfavorably* to other states in *all* Quality of Life measures.

	Alabama	Utah	Kentucky	South Carolina	Tennessee	Michigan	Georgia
Population (in millions)	**4.8**	2.9	4.4	4.8	6.6	9.9	10.2
Budget for 2016 (in billions)*							
Annual	**$29.2**	$15.1		$26.3	$34.9		$47.5
Biennial			$66.0			$54.1	
QUALITY OF LIFE							
Non-Poverty rank (out of 50)	**48**	12	47	40	41	33	44
Poverty rate per household income	**19.2%**	11.8%	19.0%	17.9%	18.2%	16.2%	18.4%
Employment rank (out of 50)	**44**	4	29	22	25	22	33
Unemployment as a % of state workforce	**5.7%**	3.2%	5.1%	4.7%	4.8%	4.7%	5.2%
Public school systems rank (out of 50)	**42**	18	17	37	36	34	35
Public school systems annual budget (in billions)	**$5.2**	$4.5	$5.5	$5.8	$5.2	$11.7	$8.6
Number of violent crimes rank (out of 50)	**12**	43	45	7	3	13	20
Prison population	**31,771**	6,364	21,657	21,401	28,769	43,390	52,949
Residents' public health assessment rank (out of 50)	**46**	7	44	42	43	35	40
Residents' access to mental health services rank (out of 50)	**50**	33	31	45	48	18	47
GOVERNMENTAL PROCEDURES & PRIVATE LOBBYISTS							
Estimated earmarked revenue	**93.0%**	47.0%	12.0%	16.0%	56.0%	63.0%	6.0%
Registered lobbyists	**603**	351	653	385	512	1,283	1,506
Number of legislators	**140**	104	138	170	131	148	236
Ratio of lobbyists to legislators	**4-1**	3-1	4-1	2-1	3-1	8-1	6-1

* Includes total budget revenue appropriated, including inter-agency transfers

The Study Group determined that, while there are many issues related to the high earmarking percentage in Alabama, there is not a direct correlation between “lower earmarking” and a better “quality of life”. Some states with lower earmarks (and similar size budgets) also had poor Quality of Life rankings.   **The Study Group concluded that high earmarking, in and of itself, does not appear to be the cause of a state’s poor quality of life**.

However, **the Study Group noted an overwhelming trend of states moving to lower earmarks as a percentage of total budget revenue.** Florida, Georgia, Louisiana, South Carolina, and Texas are just a few of the states that have trended toward a lowering of earmarks. From a common-sense perspective, unearmarking dollars provides flexibility to better direct funds to *needs and priorities*, which can positively impact a state’s quality of life measures.

The Legislature has no formal or institutionalized reviews, practices or processes in place to evaluate or determine the continued effectiveness or feasibility of earmarks on an ongoing basis.   **The Study Group recommends that the Legislature establish a standing committee to review earmarks as a matter of standard practice, with a mission to make specific recommendations for reducing the number of earmarks so that budgets can be better focused on needs and priorities.** The Legislature should place first priority on addressing statutory earmarks.

JTF STUDY GROUP REPORT

ON

TAX CREDITS, EXEMPTIONS, DEDUCTIONS AND TAX PREFERENCES

Sen. Bill Holtzclaw, Chair

Existing state tax structure results in the loss of approximately $4.5 billion in revenue to state budgets in Alabama each year. Historically, there has been little focus on how these losses of revenue affect the financing of state government. Therefore, a reporting of these credits, deductions, exemptions and preferential tax rates is necessary and required. Beginning with the 2017 Regular Session, pursuant to the provisions of Act 2015-237, the Legislative Fiscal Office is required to produce to the Legislature an annual REPORT ON ALABAMA TAX EXPENDITURES. The following information is taken from the Overview of the 2017 report:

> *"Tax expenditures are provisions of law that allow for special treatment of a source of income or certain types of expenses that results in a reduction in the tax liability for a taxpayer or group of taxpayers. In Alabama, these expenditures are established by statute and, in some cases, the Constitution. In most cases, the tax benefits realized by the taxpayer or group of taxpayers could be provided by direct appropriation; therefore, the provisions are referred to as "expenditures". Expenditures represent revenues that would have otherwise been generated if not for the preferential treatment.*
>
> *Tax expenditures are intended to achieve a policy objective or encourage some activity. The value or cost of any tax expenditure can be thought of as the amount of money required to provide the same level of support through direct appropriation rather than preferential tax treatment. The benefits of tax expenditures are received by businesses and individual taxpayers and are present in all of Alabama's major taxes, including the individual income tax, corporate income tax, and sales and use taxes.*
>
> *The purpose of this report is to list the tax expenditures for major tax sources and, where possible, provide an estimate of the value of the tax expenditures. This report does not include an evaluation or recommendation regarding the various tax expenditures as to their effectiveness in fulfilling the desired public policy objective".*

In an effort to utilize this valuable information, **it is the recommendation of this Study Group that the Legislature form a Joint Committee to review the REPORT ON ALABAMA TAX EXPENDITURES in detail and make appropriate recommendations to the Legislature at the beginning of the 2018 session.** This Joint Committee should also be tasked with determining whether the Committee would need to be permanent in nature **to make recommendations at the beginning of each session for the discontinuance or modification of these credits, deductions, exemptions and preferential tax rates.**

It is also the recommendation of this Study Group that the Legislature adopt a Joint Rule that requires that all bills that contain a credit, exemption, deduction or preferential tax rate include a Sunset provision.

JTF STUDY GROUP REPORT

ON

TAX RELIEF

Sen. Bill Hightower and Rep. John Knight, Co-Chairs

The proper function of taxation is to raise money for core functions of government -- not to direct the behavior of citizens. Taxation will always impose some level of burden on an economy's performance, but that harm can be minimized if policymakers resist the temptation to use the tax code for social engineering, political favoritism, or extraneous purposes. A principled tax system is an ideal way for advancing Alabama's economic interests and promoting prosperity for its residents.

Future Guiding Principles for Alabama

- **Simplicity –** The tax code should be easy for the average citizen to understand, and it should minimize the cost of complying with the tax laws. Tax complexity adds cost to the taxpayer, but does not increase public revenue. For governments, the tax system should be easy to administer, and should help promote efficient, low-cost administration.

- **Transparent –** Tax systems should be accountable to citizens. Taxes and tax policy should be visible and not hidden from taxpayers. Changes in tax policy should be highly publicized and open to public debate.

- **Economic Neutrality –** The purpose of the tax system is to raise needed revenue for core functions of government, not control the lives of citizens or micromanage the economy. The tax system should exert minimal impact on the spending and decisions of individuals and businesses. An effective tax system should be broad-based, utilize a low overall tax rate with few loopholes and avoid multiple layers of taxation through tax pyramiding.

- **Equity and Fairness –** The government should not use the tax system to pick winners and losers in society, or unfairly shift the tax burden onto one class of citizens. The tax system should not be used to punish success or to "soak the rich," engage in discriminatory or multiple taxation, nor should it be used to bestow special favors on any particular group of taxpayers

.

- **Complementary –** The tax code should help maintain a healthy relationship between the state and local governments. The state should always be mindful of how its tax decisions affect local governments so they are not working against each other – with the taxpayer caught in the middle.

- **Competitiveness–**A low tax burden can be a tool for a state's private sector economic development by retaining and attracting productive business activity. A high-quality revenue system will be responsive to competition from other states. Effective competitiveness is best achieved through economically neutral tax policies.

- **Reliability–**A high quality tax system should be stable, providing certainty in taxation and in revenue flows. It should provide certainty of financial planning for individuals and businesses through economically neutral tax policies.

Benefits for Alabama Using a Principled Tax System

Since taxes lower the economic welfare of citizens, policymakers should try to minimize the economic and social problems that taxation imposes. Citizens will then gain the benefits of a low tax burden. Benefits to doing so can be summarized as:

- *Greater economic growth* – A tax system that allows citizens to keep more of what they earn spurs increased work, saving and investment. A low state tax burden would mean a competitive advantage over states with high-rate, overly progressive tax systems.

- *Greater wealth creation* – Low taxes significantly boost the value of all income-producing assets and help citizens maximize their fullest economic potential, thereby broadening the tax base.

- *Minimize micro management and political favoritism* – A complex, high-rate tax system favors interests that are able to exert influence in the state capitol, and who can negotiate narrow exemptions and tax benefits that help only limited taxpayers and not the general economy. "A fair field and no favors" is a good motto for a strong tax system.

Other Actions to Improve the Taxation Process

1. **Minimize or eliminate special tax treatment, while at the same time lowering overall rates, across-the-board.** Attempting to close off these tax carve-outs without decreasing tax rates elsewhere can be a devastating blow to firms and does little to improve a state's competitiveness.

2. **Place all credits, exemptions, and deductions on the budgetary side of the fiscal ledger, giving each element visibility and require the need to budget the amount.** Also consider making the program budget-based, cash payouts instead of elements of the tax code, that reduce a firm's tax burden. This increases revenue certainty and budgetary transparency.

3. **Subject existing credits, exemptions, deductions or preferential tax rates to rigorous reporting standards to ensure transparency, and conduct a critical analysis of whether these measures are creating tangible economic growth over**

and above their true economic cost. Establish and identify in each legislative bill, the purpose of each credit, exemption, deduction or preferential tax rate so that its actual performance can be measured against its purpose (desired outcome). Also consider a sunset provision on all tax deductions, and credits, to re-evaluate their benefit.

4. **Require all future proposed tax expenditures to sunset and or face reauthorization within a set time frame (5-7 years).**

5. **Consider a formula where overall income tax rates will be reduced if revenues exceed certain levels (i.e. North Carolina).** This to be considered in conjunction with major tax reform.

6. **Conform the personal income tax as closely as possible to the federal income tax structure, using federal adjusted gross income as a starting point, to simplify filing, lower the rate and broaden the base.**

7. **Conform the corporate income tax as closely as possible to the federal cooperate income tax structure, working to simplify and implement the tax principles cited earlier in this report.**

8. **Implement other "Tax Recommendations" (pg.5) in the "Report of the Alabama Commission on Tax and Fiscal Policy Reform" published in January of 1991.**

Sources Include:

American Legislative Exchange Council

American's for Prosperity

American's for Tax Reform

INITIAL CONCLUSIONS

FROM THE

2016 JOINT TASK FORCE ON BUDGET REFORM

1) The fiscal problem that we face in Alabama must first be understood before it can be solved.

2) Currently, state government is smaller than it was 40 years ago (as percentage of Alabama GDP).

3) As stewards of the taxes paid by hard working Alabamians, we must strive to eliminate fraud, waste, and inefficiencies in state government.

4) The state tax burden on hard working Alabamians is at a 40-year low (as a percentage of per capita income).

5) While total state taxes paid has increased numerically, they have not kept pace with the economy due to the erosion of the tax base caused by changes in the way that we purchase things.

6) The Total State General Fund has grown at approximately the same rate as the Education Trust Fund over the last several years. Additional time for study is needed by the JTF to determine which part of this growth is organic, and which part is through increases in tax rates and/or shifts in allocation between the SGF and ETF.

7) We must refocus our General Fund discussion to include all revenues, not just unearmarked state funds.

8) We must reassess the role of state government, the essential services of state government, and the spending priorities of state government before we can solve our fiscal issues.

INITIAL RECOMMENDATIONS

FROM THE

2016 JOINT TASK FORCE ON BUDGET REFORM

1) Continue the work of the Joint Task Force on Budget Reform to the 5^{th} Legislative Day of the 2018 Regular Session.

2) Continue the work of the Budget Process Study Group and make formal recommendations at the beginning of the 2018 Regular Session.

3) The Agency Review Study Group should formalize a plan to review carry over funds from one fiscal year to the next and make a formal recommendation at the beginning of the 2018 Regular Session.

4) Continue the work of the Unearmarking Study Group and develop a specific plan for reduction of earmarks over time.

5) Tax Credits, Exemptions, Deductions Study Group recommends that the Legislature form a Joint Committee to review the REPORT ON ALABAMA TAX EXPENDITURES in detail and make recommendations to the Legislature at the beginning of the 2018 session. It is also recommended that the Legislature adopt a Joint Rule that requires that all bills that contain a credit, exemption, or deduction include a Sunset provision.

6) Continue the work of the Tax Relief Study Group and make a formal recommendation at the beginning of the 2018 Regular Session.