

1  PRESENTATION TO THE LEGISLATURE ON ALABAMA'S  
FINANCIAL CONDITION

2  January 9, 2006

3  I. Introduction

A. I will discuss

1. Revenue structure of the state
2. Appropriations for FY 2006
3. The U.S. and Alabama economies
4. Status of the General Fund and the ETF for FY 2005 and FY 2006
5. LFO revenue projections for FY 2007
6. Outlook for the ETF and General Fund for FY 2007
7. And update you on a few general fiscal issues

4  II. Revenue Structure

A. Earmarking

1. For FY 2006 approximately 84% of Alabama's state funds are earmarked
  - a. NCSL latest study (1997 data)
    - i. the national average was 24%
    - ii. the next highest state was Nevada at 65%
  - b. the ETF is included in this level of earmarking
2. Earmarking can be general or specific
  - a. sales taxes are earmarked for educational purposes
  - b. income taxes are earmarked specifically for public school teacher salaries
3. Earmarking can be statutory or constitutional
  - a. sales taxes are earmarked by statute
  - b. income, ad valorem, and gasoline taxes are all earmarked by the state Constitution
4. We focus on the General Fund and the ETF but the Legislature also appropriates earmarked state funds

## B. Appropriations

1. Exhibit 1 shows the appropriation of all state funds for FY 2006
    - a. total- \$9.53 billion
    - b. General Fund- \$1.56 billion
    - c. ETF- \$5.39 billion
    - d. other state funds- \$2.58 billion
  2. Exhibit 2 shows the allocation of federal funds for FY 2005 by agency
    - a. the total amount allocated was \$5.86 billion
      - i. the largest recipient of federal funds was the Medicaid program with \$2.68 billion
      - ii. the Departments of Human Resources, Education and Transportation were also large recipients of federal funds
    - b. the Alabama Legislature appropriates federal funds within the budgets
    - c. historically, the Legislature has provided open-ended spending authority for unanticipated federal funds; although since FY 2003 provisions in the General Fund budgets provide that for new federal programs or purposes, the agency must receive the approval of a majority of the Chairs of the Government Finance and Appropriations Committee and the Senate Finance and Taxation-General Fund Committee and the Governor prior to expenditure of those federal dollars
- C. Exhibit 3 shows the sources of revenue to the General Fund for FY 2005
1. Interest income – 8.98%
    - a. this includes interest on regular state deposits and a portion of interest earned on the Alabama Trust Fund
    - b. the Federal Reserve Board began raising interest rates in June 2004 when the rate was at 1%, a 46-year low; the Board has raised short term rates 13 times over the last 18 months

- c. interest income accounted for approximately 18% of the General Fund in FY 2001 (the largest source of revenue to the General Fund at that time); interest income dropped from \$206 million in FY 2001 to \$82.4 million in FY 2004 (a 60% reduction); in FY 2005 interest income increased to \$129.1 million
  2. Insurance company taxes – 16.64%
    - a. an act was passed in 2002 that created Alabama's CAPCO program which requires the Alabama Development Office to allocate up to \$100 million over 8 years in insurance premium tax credits to insurance companies that make venture capital investments in certified capital companies (CAPCO's) within Alabama
    - b. the maximum annual credits taken will be \$12.5 million
    - c. the loss to the General Fund for FY 2006 will be \$8.75 million due to these credits
    - d. impact for FY 2007-\$12.5 million
  3. Oil and gas severance taxes – 6.69%
  4. Sales tax- 7.69%
  5. Property tax- 7.02%
  6. Estate tax- only 1.01%
    - a. this tax once represented a major source of revenue to the General Fund
    - b. however, Congress provided for the phase-out of the estate tax in 2001; the federal portion of the tax is scheduled to be phased out in 2010
    - c. the state portion of the tax was phased out completely in 2005 (the estates of those who died in calendar year 2005 owe no tax)
    - d. in FY 2005, the General Fund received \$14.6 million from the estate tax down from \$80 million in FY 2002
- D. Exhibit 4 shows the sources of revenue to the ETF for FY 2005
1. Income taxes- 56.99%
    - a. individual income tax annual growth rate for FY 2000 through 2003 averaged .81%

- b. individual income tax growth rate in FY 2004 was 7.54% and in FY 2005 was 11.37%
  - c. corporate income tax growth for FY 2005 was 42.81%
  - d. the strong economic recovery was obvious in these numbers
  - e. these growth numbers are at record and unprecedented levels and our office along with many other forecasters across the country simply did not expect that level of growth
- 2. Sales taxes – 30.22%
  - a. sales tax annual growth rate for FY 2000 through FY 2003 averaged 1.01%
  - b. sales tax growth rate in FY 2004 was 7.97% and in FY 2005 was 6.16%
- 3. Utility taxes – 6.67%
- 4. Use taxes – 4.43%
- 5. All other – 1.69%
- 6. Sales and income taxes are growth taxes and are the most responsive to changes in the economy
  - a. the ETF actual receipts in FY 2005 were \$264.26 million more than LFO estimates
  - b. the questions that this office faced as we revised FY 2006 and made FY 2007 revenue projections were
    - i. will the economic recovery be sustained and
    - ii. at what level of growth

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### III. The Economy

#### A. U.S. economy

- 1. The latest reports on the U.S. economy are almost unanimously positive
- 2. The U.S. economy grew at a rate of 4.3% for the third quarter of 2005
- 3. Inflation remained modest, especially when volatile energy and food prices are removed from the calculations
  - a. prices increased at a 3.6% rate in the third quarter, but

when food and energy are excluded, prices increased at only a 1.2% rate

4. The U.S. economy was in a jobless recovery in 2002 and 2003; the economy did not begin to create jobs until February 2004 according to the Bureau of Labor Statistics
    - a. the job recovery began to accelerate in the fall of 2004
    - b. the economy continues to add jobs-almost 2 million more people were employed in November 2005 than were employed in November 2004
  5. Some national economists are predicting that the economy will grow by 3.4% in 2006 but will slow to about 3.1% growth in 2007
  6. Some of the factors that will impact those predictions include
    - a. the continued recovery from the hurricane destruction
    - b. the federal budget deficit
    - c. the decline in the value of the U.S. dollar and the severity of that decline
    - d. moderation in the price of oil
    - e. the war in Iraq
    - f. concerns about a possible drop in the housing market
- B. Alabama's economy
1. Alabama's economy was hit hard by the recession of 2001
  2. However, Alabama's economy continues an impressive recovery
    - a. Alabama began to show an increase in jobs in January 2004
    - b. Alabama reported an increase of 19,900 nonfarm jobs in November 2005 over November 2004
    - c. this is a total increase of 55,300 jobs since November 2003
  3. Alabama's personal income rose by 6.8% and 6.3% in the first two quarters of 2005

## FY 2005

- A. Beginning balance carried over from FY 2004 was \$141.06 million plus the debt service reserve of \$15.63 million for a total beginning balance of \$156.68 million
- B. Receipts in FY 2005 were \$1.4 billion
- C. Agencies' transfers of earmarked funds into the General Fund-\$18.99 million
- D. Alabama Trust Fund Board's distribution of capital gains-\$21.41 million
- E. Total available-\$1.59 billion
- F. Total expenditures-\$1.43 billion
- G. Ending balance in FY 2005- \$168.15 million
  - 1. The ending balance was \$34 million more than the Legislature anticipated and appropriated for FY 2006
- H. The Legislature had anticipated utilizing balances in two funds to balance the General Fund budget in FY 2005
  - 1. Alabama Incentives Financing Authority-\$17 million
  - 2. Exxon escrow account-\$18 million
  - 3. Since neither of those transfers were made, those amounts could be available to be appropriated in the FY 2006 or FY 2007 budget

7  V. Exhibit 6 Projected Condition of the General Fund for FY 2006 and FY 2007

- A. The General Fund began FY 2006 with a beginning balance of \$168.15 million
- B. LFO revised estimates for FY 2006 are \$1.48 billion (increased by \$100.5 million)
- C. In addition, several sources of funds will be available to be appropriated in either FY 2006 or carried forward into FY 2007
  - 1. In October, the Alabama Trust Fund Board transferred \$31.86 million in capital gains from the Alabama Trust Fund to the General Fund
  - 2. Transfer from the ETF-\$30.3 million

- a. a 1996 report from the Examiners of Public Accounts found that sales and use tax collected on “casual” sales of autos had been incorrectly distributed by the Department of Revenue
  - b. the error resulted in approximately \$28.7 million over several previous years being deposited into the ETF instead of the General Fund
  - c. the Legislature acknowledged the Examiner’s report in the ETF budget acts for FY 1997, 1998, 1999, 2000 and 2001 by providing that the payments for G.O. debt in those years would be partial payment for the debt owed by the ETF to the General Fund
  - d. in the FY 2001 ETF budget, the Legislature expressed its intent that the sales tax debt owed by the ETF to the General Fund had been paid in full
  - e. in October 2005, the Department of Finance transferred a total of \$28.7 million from the ETF to the General Fund in reference to the 1996 Examiners’ report and an additional \$1.6 million to correct an error made in FY 2005 distributions unrelated to the Examiner’s report
3. There is a balance of approximately \$12 million in the corporation escrow account
  4. Alabama Incentives Financing Authority-\$17 million that was not transferred in FY 2005 as anticipated
    - a. however, it will take action on behalf of the Authority to make this transfer
  5. Exxon escrow account-\$18 million that was not transferred in FY 2005 as anticipated
  6. Appropriated transfers from state agencies-\$5.32 million
  7. Appropriated transfer from the tobacco revenue balances-\$47.26 million
- D. Total LFO estimates to be available in FY 2006-\$1.64 billion plus the beginning balance of \$168.15 million for a total available of \$1.81 billion
- E. Current estimated expenditures for FY 2006 are \$1.56 billion

1. However, this number is lower than would have been needed because the Alabama Capital Improvement Trust Fund will pay \$65 million in debt service payments for the General Fund and related state agencies in FY 2006
- F. There are \$41.3 million in conditional appropriations in the FY 2006 General Fund budget including
1. Corrections-\$10 million
  2. Medicaid-\$10 million
  3. Department of Mental Health - \$6.5 million
  4. Department of Human Resources-\$5 million
  5. State Port Authority - \$3.5 million
  6. Department of Public Health-\$2.5 million
  7. Department of Forensic Sciences-\$1.7 million
  8. ADECA-\$1.5 million
- G. There are also some open-ended appropriations in the General Fund which may increase as the year progresses
1. FEMA-the appropriation in the budget is \$19 million
  2. The Department of Finance has indicated that an additional \$9 million will be released; this amount has been included in our current expenditure number
  3. However, it is likely that open-ended appropriations will increase over the year
- H. Based on current estimated expenditures, the projected ending balance for FY 2006 and the projected beginning balance for FY 2007 would be \$244.13 million
- I. LFO estimated receipts for FY 2007 are \$1.49 billion
- J. Total amount projected to be available for FY 2007 is \$1.73 billion
- K. This is \$170.97 million more than current projected expenditures for FY 2006 (but remember the FY 2006 appropriation is artificially low due to debt being paid from the Alabama Capital Improvement Trust Fund); and this assumes that \$244.13 million is carried forward from FY 2006 to FY 2007 which means
1. That conditional appropriations will not be released nor



open-ended appropriations increased

2. The Legislature does not enact any supplemental appropriations from the General Fund for FY 2006
3. The transfers listed on your exhibit are transferred to and/or remain in the General Fund

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## VI. Outlook for the General Fund for FY 2007-What Happened to the Deficit?

A. The Legislature utilized a number of one-time measures totaling \$245.26 million in order to balance the FY 2006 General Fund budget

1. An estimated beginning balance of \$133 million that was considered one-time when the budget was passed
2. Debt service payments appropriated from the Alabama Capital Improvement Trust Fund to free up funds for the General Fund and state agencies in FY 2006-\$65 million
  - a. G.O. debt reserve account-\$15.59 million
  - b. state parks and historical sites G.O. debt-\$8.94 million
  - c. General Fund state agency debt payments-\$22.18 million
  - d. G.O. debt usually paid by Department of Transportation-\$18.14 million
3. Sweep of balances in tobacco accounts-\$47.26 million

B. Several things have happened since the FY 2006 General Fund budget was passed to counter this \$245.26 million deficit that you thought you would be addressing for FY 2007

1. FY 2005 ended with a balance \$34 million higher than the balance anticipated when the budget was passed (\$133 million)
2. \$31.86 million was transferred to the General Fund by the Alabama Trust Fund Board from capital gains
3. The \$18 million transfer from the Exxon escrow account was not made and is still available
4. \$30.3 million was transferred from the ETF by the Finance Director
5. The \$17 million transfer from the Incentives Financing

Authority was not made and is still available if the Authority approves the transfer

6. \$12 million in the corporation tax escrow account is estimated by the LFO to be available for transfer to the General Fund
  7. Additional revenue growth due to LFO increased estimates for FY 2006 (\$100.5 million), carrying that same amount in the base for FY 2007 (\$100.5 million) and estimated growth for FY 2007 (\$7.3 million)-\$208 million
  8. These changes and revisions total \$351 million
- C. Therefore, approximately \$106 million could be available for other needs in the General Fund after accounting for paying the debt service payments from the General Fund in FY 2007
- D. However there are still fiscal challenges facing the General Fund for FY 2007
1. The retirement rate paid by employers will increase from 6.77% to 7.78%
    - a. total estimated increased cost of \$15.5 million
    - b. General Fund agencies-\$5.2 million increased cost
  2. The health insurance premium for state employees as requested by SEIB will increase from \$650 per month to \$735 per month per employee
    - a. total increased cost- \$36 million
    - b. General Fund agencies increased cost- \$12 million
  3. The cost of a 1% pay increase for state employees
    - a. total cost-estimated \$15 million
    - b. cost to the General Fund-estimated \$5 million
- E. Budget request increases from the General Fund agencies for FY 2007 total approximately \$630 million-some highlighted agency requests include
1. Medicaid Agency
    - a. the Medicaid Agency has requested an increase from the General Fund for FY 2007 of \$92.7 million
    - b. however, a pending conference committee report in Congress is expected to forgive the state match in the 11

Alabama counties eligible for individual assistance due to Hurricane Katrina for approximately 10 months

- i. this will amount to a \$147.4 million savings for the Medicaid Agency that can be carried forward and expended in FY 2007
  - ii. in addition, state agencies that provide Medicaid services will also realize savings
    - a) Mental Health-\$4.6 million
    - b) Public Health-\$2.2 million
    - c) Human Resources-\$3.5 million
    - d) Senior Services-\$1.2 million
    - e) Youth Services-\$200,000
2. Department of Public Health
- a. Children's Health Insurance Program-\$2.9 million increase to cover an estimated 75,609 eligible children
  - b. other services-\$11.1 million requested increase
  - c. the medical community is greatly concerned about the possibility of a bird flu pandemic
    - i. there is no approved vaccine available
    - ii. antiviral agents such as Tamiflu are in short supply
    - iii. the federal government has mandated that 81 million doses be stockpiled in case of a bird flu pandemic
    - iv. Alabama's share is approximately 500,000 doses
    - v. the Department is requesting a conditional appropriation of \$22 million for FY 2007 to cover the cost of antiviral agents or vaccines in the event of a pandemic
3. Department of Mental Health
- a. is requesting a \$43.7 million increase from the General Fund in FY 2007 and a \$12.1 million increase from the ETF (\$10.3 million of the additional increase from the ETF is for a transfer of mental retardation day habilitation services that are funded from the General Fund in FY 2006)
  - b. if the funding source is not transferred to the ETF the

- additional request from the General Fund is \$54 million
  - c. of the \$43.7 million requested increase, \$18.7 million is requested to maintain the same level of services in FY 2007 as budgeted to be provided in FY 2006
  - d. the cost to maintain level services increases to \$29 million if the cost for day habilitation services is not transferred to the ETF
4. Department of Human Resources
- a. is requesting a \$25.5 million increase from the General Fund of which \$12.4 million is to maintain services at FY 2006 levels
5. Indigent defense payments
- a. the Attorney General issued an advisory opinion in February 2005 stating that a change in the law dealing with payments for the defense of indigent clients had eliminated the authorization for the Comptroller to pay overhead expenses not directly related to each client
  - b. the Circuit Court of Montgomery County issued an order in September 2005 reinstating payments statewide for overhead expenses and providing for retroactive payments
  - c. the Department of Finance has filed a motion to stay that order with the Alabama Supreme Court
  - d. the Comptroller continues to pay overhead expenses for attorneys in Covington County pursuant to a court order affecting only that county
  - e. if overhead expenses are authorized to be paid retroactively and prospectively either by court order or legislation
    - i. FY 2005 payments are estimated to be \$3.2 million (\$10.2 million was expended in FY 2005 for general overhead expenses incurred prior to the AG's opinion)
    - ii. FY 2006 payments are estimated to be \$14.4 million
    - iii. FY 2007 payments are estimated to be \$16 million
    - iv. for a total of \$33.6 million additional dollars

6. Department of Corrections

- a. the Department is requesting a \$283.7 million increase in General Fund dollars for FY 2007 including
  - i. \$191.1 million for capital outlay
    - a) \$75 million for construction of a 2000 bed facility for female inmates
    - b) \$75 million for the construction of a 2000 bed facility for male inmates
    - c) \$41.1 million for improvements of existing facilities
  - ii. \$27.2 million increase for contracts to house 2000 male inmates and an additional 185 female inmates in private beds
  - iii. \$13 million increase for transportation equipment purchases
  - iv. \$23.8 million increase for personnel costs and employee benefit increases
- b. the Department is requesting \$5.52 million for Community Corrections programs
- c. state prisoners in county jails
  - i. in FY 2004, the state eliminated the backlog of state prisoners in county jails because of the expedited parole hearings and the housing of state prisoners out of state
  - ii. however, the number of inmates eligible for parole has been exhausted and the Department reports that there is again a backlog of state prisoners in county jails
  - iii. on January 4, 2006 Montgomery Circuit Court held a hearing in response to a motion filed by the plaintiffs requesting that the court find the Commissioner in contempt for failure to comply with the December 2002 order in which counties would be allowed to send up to 275 state prisoners to the Department each week; the court has not ruled on that motion

7. Board of Pardons and Paroles
  - a. during the 2003 Second Special Session, legislation was enacted to establish four special member positions to the Board effective October 1, 2003 and ending effective September 30, 2006
    - i. this special board began considering special dockets effective December 2003
    - ii. 9,441 special hearings have been held and 4,185 inmates have been paroled; these parolees are in addition to 2,713 regular parolees
  - b. the Board operates a transition center for female inmates who are not yet ready for probation or parole without additional support
    - i. currently there are 185 residents of the program
    - ii. more than 500 residents have completed the program
    - iii. the Board plans to open a transition center for male probationers and parolees by April 2006
  - c. the Board is requesting an increase from the General Fund of \$16.3 million for FY 2007
8. Department of Public Safety
  - a. is requesting an increase of \$59.6 million from the General Fund
    - i. this request includes \$15 million in capital outlay for a new training facility
  - b. the Department is offering an accelerated training academy to persons with at least two years experience in law enforcement
    - i. trooper training usually takes six months but qualified POST- certified trainees will train for only 14 weeks
    - ii. the department is budgeted to hire 200 new troopers in FY 2006
9. Unified Judicial System is requesting an additional \$13.4 million from the General Fund
  - a. approximately \$4 million of this request is to replace funds from the Capital Improvement Trust Fund

appropriated for FY 2006 to pay rent (used to pay debt service on a bond issue)

9  VIII. Exhibit 7 Condition of the ETF for FY 2005

- A. Beginning unappropriated balance carried over from FY 2004 was \$181.57 million plus the \$8.34 million reserve for the October 1, 2004 debt service payment
- B. Actual receipts in FY 2005 to the ETF were \$4.97 billion (\$264.26 million more than LFO projections)
- C. Total available for expenditure in FY 2005 was \$5.16 billion
- D. Total expenditures were \$4.59 billion plus \$8.87 million for the debt service reserve for the October 1, 2005 payment
- E. Ending balance in FY 2005 was \$562.09 million plus \$8.87 million for the debt service reserve
- F. The anticipated balance which was appropriated in the FY 2006 ETF budget was \$283.92 million

10  IX. Exhibit 8 Projected Condition of the ETF for FY 2006 and FY 2007

- A. There are 2 provisions in the FY 2006 ETF budget act that affect the balance for FY 2006
  - 1. The Legislature provided that in the event the amount of revenue in the ETF carried forward exceeded the \$283.92 million anticipated and appropriated for FY 2006, the Finance Director was directed to automatically release appropriations totaling \$13 million to the four-year institutions of higher education and he did so in October
  - 2. There are two funds set up to deal with proration in the ETF
    - a. one is the Constitutional Rainy Day Account within the Alabama Trust Fund in which \$248 million was set aside for ETF proration
    - b. the ETF utilized \$180 million of this fund in FY 2003 when the fund was in proration
    - c. in FY 2006, we are in the third year of repayment to that fund

3. In addition, Section 40-1-32.1 in the Alabama Code established a statutory ETF Proration Prevention Account and provided that 20% of the unappropriated and unanticipated ending balance of any fiscal year would be transferred to this account by the Finance Director at the beginning of the next fiscal year and provided further that the transfers would continue to be made until the account reached \$75 million
  - a. there was a balance of \$17 million in the fund at the end of FY 2005
  - b. the Legislature made an absolute appropriation of \$18 million to that account in the FY 2006 budget
  - c. in addition, the Legislature provided in the FY 2006 budget act that notwithstanding the provisions of Section 40-1-32.1, in the event the beginning balance for FY 2006 exceeded \$283.92 million, 75% of the unappropriated beginning balance (after the release of the \$13 million to the universities) would be transferred to that fund
  - d. the amount transferred was \$198.88 million
  - e. the balance in the statutory Proration Prevention Account will be \$233.88 million at the end of FY 2006
- B. Therefore, the ETF began FY 2006 with a beginning balance of \$562.09 million plus a \$8.87 million reserve for the October 1, 2005 debt payment
- C. LFO revised estimates for FY 2006 total \$5.25 billion
- D. Conditional appropriations in the FY 2006 ETF budget total \$8 million
  1. Department of Mental Health for ARC programs-\$965,615 (co-first priority conditional)
  2. Two-year college system for Step 25 salary step-\$3.4 million (co-first priority conditional)
  3. Fire College-\$1.3 million (co-first priority conditional)
  4. Department of Children's Affairs-\$1,035,000
  5. Department of Education for eye screening in Grade 2-



\$732,246

6. Camp ASCCA-\$226,085

7. Department of Public Health-AIDS ALABAMA-\$200,000

8. Governor's Office on Faith-Based & Community Initiatives-\$150,000

9. All of these conditional appropriations in the ETF for FY 2006 have been released

E. Therefore, the estimated expenditures including the release of all conditionals total \$5.18 billion plus \$8.84 million for the debt service reserve

F. There was the transfer of \$198.88 million to the Statutory Proration Prevention Account pursuant to the provisions of the FY 2006 ETF budget act (75% of the unanticipated and unappropriated beginning balance) so total expenditures became \$5.39 billion

G. The LFO projected ending balance for FY 2006 and the beginning balance for FY 2007 is \$431.92 million plus \$8.84 million for the debt service reserve

H. LFO estimated receipts for FY 2007 are \$5.58 billion

1. this is a growth rate of 6.27%

I. Total amount projected to be available for appropriation from the ETF in FY 2007 is \$6.02 billion

J. This equates to \$829.61 million available to be appropriated in FY 2007 more than the current level of appropriations in FY 2006 including the release of the conditional appropriations but excluding the transfer to the Proration Prevention Account

K. There will be \$233.88 million in the Statutory Proration Prevention Account

L. The ending balance for FY 2006 and the beginning balance for FY 2007 does not take into account any supplemental appropriations that could be enacted by the Legislature for FY 2006 from the ETF

11  X. Outlook for the ETF for FY 2007

A. Some of the fiscal issues in the ETF include

1. The premium for health insurance for teachers and support

personnel under PEEHIP is projected to increase from \$668 per month per employee to \$717 (an increase of 7.34%)

- a. K-12 increased cost to the ETF is \$44.98 million
  - b. 2-year schools increase of \$3.15 million
  - c. Alabama Institute for the Deaf and Blind increase of \$500,000
  - d. increased cost of \$4.4 million for university retirees
2. The retirement rate will increase from 8.17% to 9.36%
    - a. increased ETF cost of \$28.83 million for K-12
    - b. increased ETF cost of \$2.98 million for the 2-year colleges
  3. Repayment of 20% to the Rainy Day Account-\$36 million
    - a. there are 2 years remaining to fully repay the Rainy Day Account
  4. Cost of 1% pay increase
    - a. K-12 (including teachers and support personnel)-\$28.19 million cost to the ETF
    - b. two-year colleges-\$2.93 million cost to the ETF

#### B. Reading Initiative update

1. Alabama began state funding of the Reading Initiative in FY 2000 with \$6 million; there were 81 schools utilizing the Reading Initiative that year
2. In FY 2006 the ETF appropriation of \$40 million plus the \$16 million conditional appropriation released in September 2005 will cover 752 schools
3. In addition, the remaining 149 K-3 schools will receive ARI training in the summer of 2006
4. The Department is requesting \$55 million from the ETF for the Reading Initiative in FY 2007
5. In addition, Alabama has received federal funds for the Reading First Initiative which will serve 93 schools in 46 local systems in FY 2006
  - a. FY 2003: \$16.11 million
  - b. FY 2004: \$18.08 million
  - c. FY 2005: \$18.33 million

d. FY 2006: \$18.6 million

C. Funding for extension of the school year

1. The cost of each additional instructional day from the ETF for FY 2007 is \$15.55 million
2. The Department of Education is requesting an increase of 5 days

D. Other K-12 requests

1. The Department of Education is requesting an increase of \$13 million for school nurses to restore the phase-in schedule provided for by law
2. The Department is also requesting an increase of \$21.37 million for new physical education teachers and \$22.18 million for new special education teachers

E. The Alabama Commission on Higher Education's Unified Budget Recommendation requests an increase of \$161.07 million for higher education

F. Total budget requests for increased funding from the ETF for FY 2007 total more than \$636.97 million and this amount does not include the cost of a pay raise

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XI. General Fiscal Issues

A. The Governor's Task Force on Prison Crowding released its final report on October 27, 2005 which contained six recommendations dealing with sentencing guidelines, criminal punishments and ways to alleviate prison crowding

B. Exhibit 9 shows the history and status of the Alabama Capital Improvement Trust Fund

1. This trust fund was established by Constitutional Amendment 666 and is funded with 28% of the royalties deposited into the Alabama Trust Fund in the previous fiscal year
2. The amendment also created a Bond Commission with authority to issue up to \$350 million in economic development bonds
  - a. the Commission has issued \$243.88 million in bonds to date

- b. the remaining bond authority is \$106.12 million
  - c. royalties are used to pay debt on these bonds
  - d. the remaining royalties in the ACITF may be used for other debt of the state or economic development purposes
3. The beginning balance in the Alabama Capital Improvement Trust Fund for FY 2005 was \$89.89 million
  4. The 28% of royalties deposited into the Capital Improvement Trust Fund in FY 2005 amounted to \$72.76 million
  5. \$22.84 million is projected to be expended for “regular” debt service in FY 2006 for bonds pledged under Amendment 666
  6. In order to give relief to the General Fund budget in FY 2006, the Legislature paid some G.O. debt and the debt service obligations for several state agencies from the Capital Improvement Trust Fund for FY 2005 and FY 2006
    - a. FY 2005 relief-\$46.58 million
    - b. FY 2006 relief-\$65.03 million plus debt service reserve of \$15.59 for the October 1, 2006 payment
  7. The Legislature also appropriated \$80 million from the Capital Improvement Trust Fund for the State Docks
  8. The unappropriated ending balance in the Alabama Capital Improvement Trust Fund was \$79.67 million for FY 2005
  9. The projected ending balance for FY 2006 is \$11.38 million
  10. Based on LFO projections for royalties in FY 2007, the ending unobligated balance in the ACITF for FY 2007 would be \$39.56 million if additional bonds are not issued by the Commission and the Legislature does not make any additional appropriations from the ACITF

#### C. Tobacco Settlement Update

1. Alabama along with 45 other states, the District of Columbia, and certain American territories reached an agreement with the major tobacco companies in November 1998
2. Alabama began receiving payments from this settlement in

2000

3. Since May 2000, the state has received a total of \$679.4 million
4. The state is estimated to receive an additional \$105.4 million in 2006 and an estimated \$106.8 million in FY 2007
5. Exhibit 10 shows amounts received for FY 2000 through FY 2005 and the estimated amounts for FY 2006 and FY 2007
6. Exhibit 11 shows the allocation of the \$679.4 million received to-date
  - a. the 21<sup>st</sup> Century Fund has been allocated \$66 million for debt service
  - b. there were one-time allocations of
    - i. \$143,000 for attorney fees
    - ii. \$500,000 for tobacco growers
    - iii. \$19.4 million for the General Fund
    - iv. \$19.4 million for Medicaid
  - c. other allocations include
    - i. Children First Trust Fund-\$343.79 million
    - ii. Senior Services Trust Fund-\$10.16 million
    - iii. Medicaid-\$204.8 million
    - iv. Department of Senior Services for the Medicaid Waiver program- \$15.24 million

D. Annual equalization of property taxes

1. The Department of Revenue and local tax officials are in the third year of implementing a program of annual equalizations in which property will be revalued on an annual basis rather than every four years
2. Montgomery County has utilized annual equalization since 1995
3. Thirty counties have implemented annual equalization
4. An additional 17 counties are scheduled to implement annual equalizations this year
5. All counties are scheduled to have implemented annual appraisals by October 1, 2008

E. Sales tax exemption for contractors on construction contracts

with public entities

1. The Legislature passed an act in 2004 repealing a sales tax exemption for contractors for the materials used for construction contracts with public entities
2. The repeal of this exemption was originally designed to be for FY 2005 and FY 2006
3. LFO estimates for FY 2006 include \$37.2 million in the General Fund as the result of removal of this exemption and changing the distribution formula for the sales tax on autos that goes to the General Fund
4. However, an Attorney's General opinion found that the language that the "amendatory act terminated on October 1, 2006" was insufficient to revive the previous provisions of Section 40-9-33 which allowed the exemption; however, the distribution formula will revert to the pre-2004 percentages
5. Therefore, it will require an act of the Legislature to reenact the exemption for contractors from the payment of sales tax on materials used for contracts with public entities
6. If the exemption is not reinstated or the distribution formula is not changed, an estimated \$55.8 million will go to the ETF and not the General Fund due to the distribution percentage reverting to the previous calculations
7. This amount has been included in the LFO's revenue estimates for the ETF for FY 2007

#### F. Hurricane update

1. Hurricane Katrina affected Alabama in many ways
  - a. 22 Alabama counties were declared disaster areas and thus eligible for FEMA assistance
    - i. 11 counties are eligible for both individual and public assistance
    - ii. the other 11 counties are eligible for public assistance only
  - b. many evacuees from Mississippi and Louisiana came to Alabama and many are still here
2. Federal assistance for Hurricane related expenses in

Alabama has totaled more than \$580 million

- a. more than 250,000 Katrina victims have received food stamps
  - b. there have been one-time cash assistance checks for more than 3,000 families
  - c. more than 35,000 individuals and families have received housing and rental assistance through FEMA
  - d. Medicaid has covered almost 4,000 out-of-state evacuees
  - e. more than 7,200 evacuees are in Alabama public schools
3. Hurricane Katrina also had a large impact on agriculture
- a. the timber industry was hardest hit with estimated losses of \$200 million
  - b. the seafood industry had losses estimated to be \$88 million
  - c. the Department of Agriculture and Industries estimates total losses of more than \$400 million in agriculture related industries

G. Governmental Accounting Standards Board (GASB) rule

1. Historically state and local governments have funded retiree healthcare benefits on a “pay-as-you-go” basis and therefore, those costs have not been valued nor reported on the state’s balance sheet
2. GASB has adopted a new rule that will require states to report these incurred costs on their financial statements for FY 2008 (SEIB and PEEHIP will begin reporting these costs in FY 2007)
3. Actuaries for both the State Employees’ Insurance Board and the PEEHIP Board are currently performing the valuations necessary for the state to comply with this new rule
4. The GASB rule requires governments to disclose their liability for future retiree healthcare costs prospectively which means that states will not be required to report their total unfunded liability upfront
5. The rule requires that states report their annually accruing

cost of future health benefits, whether they have provided funds to offset all or some portion of that cost and the amount of the cost that is unfunded

6. Although GASB does not require states to fund these liabilities, policy makers in each state will have to decide how they will deal with a potentially large liability on the state's financial statement

#### H. Status of selected pending litigation

##### 1. Update on Exxon litigation

- a. in 1999 Alabama filed a lawsuit against Exxon alleging that the company intentionally underpaid oil and gas royalties owed the state
- b. in 2000 a jury awarded the state \$3.5 billion (\$3.42 billion in punitive damages and \$87.7 million in compensatory damages)
- c. Exxon agreed to give the state an \$18.2 million non-refundable payment in lieu of posting 10% of the judgment as a supersedeas bond for the appeal
- d. in 2002 the Alabama Supreme Court reversed the verdict and remanded the case for a new trial
- e. in 2003 a second jury awarded the state \$11.9 billion (\$11.8 billion in punitive damages and \$102.8 million in compensatory damages)
- f. in 2004 a Montgomery County Court reduced the verdict to \$3.6 billion (\$3.5 billion in punitive damages and \$102.8 million in compensatory damages)
- g. Exxon appealed the verdict to the Alabama Supreme Court which ordered mediation
- h. the mediation was unsuccessful and the case is now back before the Alabama Supreme Court
- i. the state requested oral arguments in this case before the Alabama Supreme Court in August 2005
- j. that motion is pending

##### 2. Update on Reynolds lawsuit

- a. this lawsuit was filed against the Department of



- Transportation in 1985 alleging racial discrimination in hiring and promotion practices
- b. as of November 30, 2005, the Department had paid
    - i. \$67 million in legal costs
    - ii. \$39.4 million in consultant costs
    - iii. \$55.59 million in hiring and promotion settlement costs
    - iv. \$6 million in back pay and retirement benefits to 20 individuals that the court found were negatively affected by the changes made to the qualifications for the position of Graduate Civil Engineer
    - v. \$14 million in non-compliance fines (historically at \$63,000 per week and later reduced to \$31,500 per week)
  - c. non-compliance fines were suspended by the court in December 2004 and certain portions of the consent decree were rendered unenforceable
    - i. the court ordered that 85% of the unenforceable fines be refunded to the Department, a refund totaling \$3.88 million
  - d. part of the consent decree has expired and the remaining provisions are scheduled to expire December 31, 2006
  - e. the Department reports that it is now in full compliance and that minimum qualifications and exams have been prepared and approved by the State Personnel Department
3. Update on Crum lawsuit
- a. Crum is a class action lawsuit in federal district court in which the plaintiffs claim that approximately 23 state departments engaged in racial discrimination in hiring and promotion practices
  - b. this case has not proceeded in the past year
  - c. a total of \$13.28 million has been expended by the state on expenses related to this case since 2002
4. Lawsuit challenging the constitutionality of Community

## Services Grants

- a. in May 2004 a taxpayer filed a lawsuit in Montgomery County challenging the constitutionality of the \$11.7 million appropriation from the ETF to the Community Services Grant Program for FY 2005 and the statute which prescribes the duties of the Joint Legislative Oversight Committee on Community Services Grants
  - b. the plaintiff alleged that the appropriation and statute violated the separation of powers doctrine in the Alabama Constitution
  - c. the Joint Fiscal Committee exercised its legal authority to intervene in the lawsuit to defend the legislative interest in the lawsuit
  - d. the Montgomery Circuit Court conducted a bench trial and issued an order in which the court found that the plaintiff had failed to produce evidence that either the Joint Legislative Oversight Committee on Community Services Grant statute or the FY 2005 \$11.7 million appropriation violated the Alabama Constitution
  - e. in December 2004 the plaintiff filed a notice of appeal with the Alabama Supreme Court
  - f. on September 30, 2005 the Alabama Supreme Court, in a 7-0 opinion, held that the Community Service Grants were an “encroachment on the executive powers specifically reserved to the executive branch of government by the Alabama Constitution”
  - g. the Alabama Supreme Court reversed and remanded the case
  - h. the trial court has not taken further action on this matter to date
5. Knight v. Alabama
- a. the federal court remedial decree issued in 1995 was scheduled to terminate on August 1, 2005
  - b. negotiations to reach a final settlement have been unsuccessful
  - c. attorneys for Alabama State University and Alabama A

& M University have asked the court to maintain jurisdiction and to order the state to maintain enhanced funding for the approved new programs, continue funding of diversity and needs-based scholarships and require some historically white institutions to increase black faculty and staff

d. no ruling has been made at this time

13  XII. Closing Remarks