S T A T E O F T E N N E S S E E
OFFICE OF THE
ATTORNEY GENERAL
PO BOX 20207
NASHVILLE, TENNESSEE 37202

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Opinion No. 02-031

Appropriations Exceeding Revenues

QUESTIONS

The Commissioner of Finance and Administration has reported to the Senate Finance, Ways, and Means Committee that, absent additional revenues, appropriations for the 2001-2002 fiscal year will exceed available revenues.

1. What will be the legal consequences if available reserves and revenues do not equal appropriations toward the end of the State's fiscal year?

2. What will be the legal consequences if the State Comprehensive Annual Financial Report reflects that expenditures for the fiscal year exceeded revenues?

OPINIONS

1. In the event that available reserves and revenues are not enough to fund appropriations, the State may not constitutionally borrow money to cover current operations unless that debt is to be repaid within the current fiscal year. When available cash, whether from revenues, reserves, or debt, is not enough to cover the State's current operations, then the State will not be able to pay for them. At that point, the State may be in violation of its contracts or its other legal responsibilities, including its statutory and constitutional obligations to fund education and operate corrections facilities, as well as its obligations to comply with outstanding court orders. In all of these cases, the State may be subject to damages and other legal penalties for failure to carry out its legal responsibilities.

2. The Comprehensive Annual Financial Report reflects expenditures and revenues on an accrual basis and is typically prepared several months after the end of the fiscal year. It could be argued that if the Comprehensive Annual Financial Report reflects that expenditures exceeded revenues, legally available reserves, and debt proceeds during the previous fiscal year, then the General Assembly has violated Article II, Section 24 of the Tennessee Constitution. Because a deficit of this type cannot be ascertained for several months following the end of the fiscal year, and the Constitution specifies no remedy, however, there is no judicial remedy for a violation of this type.

ANALYSIS

You have asked about the legal consequences arising out of a predicted shortfall in state revenues over appropriations for the current fiscal year. The Commissioner of Finance and Administration has advised the Senate Finance, Ways, and Means Committee that revenues for the current 2001-2002 fiscal year will not be enough to fund all appropriations made by the General Assembly. The General Assembly may attempt to address the predicted shortfall by levying additional taxes or utilizing various reserves, some of which may be available only through changes in existing legislation.

Your question specifically asks the legal consequences if "the state ends the fiscal year unable to balance and therefore unable to close the books . . .." We assume your question refers to the current fiscal year 2001-2002, and is concerned with the legal effect if state expenditures exceed state revenues and reserves. As a practical matter, we think this situation could be reflected in two different ways. First, there simply may be no legally available cash to pay for the day-to-day operations of state government, including such expenses as salaries and purchases of goods and services. Finally, the State's Comprehensive Annual Financial Report, which is prepared several months after the end of the fiscal year, may reflect that expenditures for fiscal year 2001-2002 exceeded revenues, legally available reserves, and debt proceeds for that year.

1. Exhaustion of Available Cash

Both these questions require interpretation of Article II, Section 24 of the Tennessee Constitution. That section provides in relevant part:

> No public money shall be expended except pursuant to appropriations made by law. *Expenditures for any fiscal year shall not exceed the state's revenues and reserves, including the proceeds of any debt obligation, for that year.* No debt obligation, except as shall be repaid *within the fiscal year of issuance*, shall be authorized for the current operation of any state service or program, nor shall the proceeds of any debt obligation be expended for a purpose other than that for which it was authorized.

Tenn. Const. Art. II, § 24 (emphasis added). Article II, Section 24 by implication authorizes state expenditures for any fiscal year to include revenues, reserves, and the proceeds from any notes or bonds issued in that year. Revenues would include monies from payment of tax obligations due in the current fiscal year as well as federal grants to fund services and projects for the current fiscal year. Reserves would include monies received in earlier fiscal years and retained as a surplus and legally available to be disbursed. Bond proceeds would include the proceeds from any notes or bonds issued in that fiscal year; these proceeds may represent a lump sum of cash that must be repaid over many years.

As a practical matter, Article II, Section 24, in effect, provides that state government may spend only cash it has on hand from these three available sources. The State may not borrow money to cover its current operations, nor may it divert cash from bonds issued for other purposes to cover current operations, nor may it use other funds, if any, in its possession but not legally available to the State, for example, funds held in trust. If the State experiences a cash shortage in a fiscal year, the only way it may borrow money to cover current operations is to incur a debt that must be repaid within the same fiscal year. If the State does not have cash to pay for its current operations, it cannot issue long-term debt to cover them. In that case, the State will be unable to pay for its current operations. If the State fails to make payments under outstanding contracts for goods or services, it may be in default of each of those contracts.

The consequences of the legal inability to pay for current operations could be dire. If the State fails to maintain services required by the state constitution and/or statutes, then it will be in violation of those statutory and constitutional provisions. For example, the constitution imposes upon the General Assembly the obligation to maintain and support a system of free public schools that affords substantially equal educational opportunities to all students. Tenn. Const. Art. XI, Sec. 12; *Tennessee Small School Systems v. McWherter,* 851 S.W.2d 139, 141 (Tenn. 1993). If the State fails to pay for the educational system, it will be in violation of that obligation. In addition, the State is bound by certain court orders to provide certain services and to maintain certain activities. If the State ceases to provide those services or to maintain those activities as a result of a shortage of funds, the State may be held in contempt of those court orders. In all of these cases, the State may be subject to damages and other legal penalties for failure to carry out its legal responsibilities.

2. Expenditures Exceeding Revenues on Consolidated Annual Financial Report

Your question expressly refers to the ability of the State to "close its books" at the end of the fiscal year. We assume your concern is that the State's Comprehensive Annual Financial Report may reflect that expenditures for fiscal year 2001-2002 exceeded revenues, including funds from certain reserves that were appropriated in the State's budget. State financial operations are reported on an accrual basis. Under this system, an expenditure is recorded when a state agency incurs an obligation, not when the bill is actually paid by a disbursement of available funds. Revenues are also recorded before cash is actually received. After the fiscal year closes, state officials will prepare the State's Comprehensive Annual Financial Report. This report will include a Combined Statement of Revenues, Expenditures, and Changes in Fund Balances, summarizing revenues and expenditures for the year, and a Combined Balance Sheet. The Combined Balance Sheet will include fund balances that will be the starting point for the next fiscal year.

We assume your question is whether any state law will be violated if, when the State's Annual Report is prepared several months after the end of the fiscal year, total expenditures made in fiscal year 2001-2002 exceed total revenues received in the same year and identified reserves legally available for disbursement. In that event, fund balances on the Combined Balance Sheet could be lower than they were at the end of the preceding fiscal year.

The precise limitations imposed by Article II, Section 24 upon this State's authority to run an accounting deficit of this kind are not clear at this time. The North Carolina Court of Appeals, under an analogous provision of the North Carolina Constitution, concluded that an "expenditure" occurred only when funds were actually disbursed, not when an obligation was incurred. *Boneno v. State,* 54 N.C. App. 690, 284 S.E.2d 170 (1981). The Court concluded that "[o]nly actual expenditures in excess of receipts would violate the provision." *Id.* at 171. Since Tennessee's Comprehensive Annual Financial Report reflects certain obligations as expenditures before cash is spent to satisfy those obligations, the report would not necessarily reflect only the actual cash disbursements and receipts for that fiscal year. If the term "expenditures" as used in Article II, Section 24 of the Tennessee Constitution were construed as referring only to actual cash disbursements, the constitutional prohibition would not necessarily be violated if the annual report reflected only an accounting deficit.

This Office has reviewed the discussions of this sentence of Article II, Section 24 at the Constitutional Convention of 1977, which adopted it. Nothing in those discussions specifically indicates that the members of the convention intended the provision to be interpreted as incorporating accrual basis accounting methods. On the other hand, it appears that, at the time the provision was adopted, the State's finances were accounted for on a modified accrual basis, a practice recommended under Governmental Accounting and Financial Reporting Principles in accordance with statements issued by the National Council on Governmental Accounting around that time. If other evidence showed that the members of the convention were aware of this practice and that this portion of Article II, Section 24 was drafted with this definition of "expenditures" in mind, then a court could conclude that the provision is violated if the State's Comprehensive Annual Financial Report reflects that expenditures for the previous fiscal year exceeded revenues, available reserves, and bond proceeds for the same fiscal period, notwithstanding the fact that the actual cash expended did not exceed the actual cash revenues, reserves, and bond proceeds legally available.

This conclusion, however, presents several problems. First, Article II, Section 24 expressly allows expenditures to include available reserves and debt proceeds in addition to current, annual revenues. On its face, the constitutional limitation thus seems to adopt a cash analysis, rather than an accrual basis accounting one. Under this reading, Article II, Section 24 would not be violated, therefore, if actual cash disbursements did not exceed the total of current revenues, available reserves, and proceeds from bonds issued in the fiscal year. Second, accounting rules and practices change over time. It is not clear that, in adopting Article II, Section 24, the members of the Constitutional Convention of 1977 intended to incorporate evolving accounting rules and principles into the Tennessee Constitution. Further, the Consolidated Annual Financial Report, while it reflects the State's finances as of the last date of the fiscal year, is not complete until several months after the fiscal year ends.

Article II, Section 24 provides no judicial remedy even if the Consolidated Annual Financial Report reflects that, as of several months earlier, the State was in violation of this provision. The exclusive control of the expenditure of the public moneys is vested in the legislative branch of the government, and is the subject of limitation by the courts only so far as provided by the Constitution. *State ex rel. Weldon v. Thomason*, 142 Tenn. 527, 221 S.W. 491, 494 (1919)*; see also Peay v. Nolan*, 157 Tenn. 222, 7 S.W.2d 815 (1928). For this reason, we think a violation of Article II, Section 24 under this interpretation could not be addressed by the judiciary. *See*, *e.g.*, *Mayhew v. Wilder*, 46 S.W.3d 760 (Tenn.Ct.App. 2001), *p.t.a. denied* (2001) (describing the characteristics of a non-justiciable political question).

PAUL G. SUMMERS
Attorney General and Reporter

MICHAEL E. MOORE
Solicitor General

ANN LOUISE VIX
Senior Counsel

H. PHILLIP CARNES
Senior Counsel

Requested by:

Honorable Douglas Henry
State Senator
Suite 11, Legislative Plaza
Nashville, TN 37243-0021