



Comments on Your Government

A SPECIAL PUBLICATION OF THE RHODE ISLAND PUBLIC EXPENDITURE COUNCIL

RIPEC

FY 2003 State Budget Analysis

RIPEC's analysis of the Governor's FY 2003 budget includes an unprecedented letter signed by the members of the RIPEC Board of Directors. This letter attempts to highlight the Board's concerns about trends in state spending and the projected operating budget deficits.

Just a decade ago the Rhode Island economy was rocked by a national recession which was exacerbated by a credit union crisis. As painful as the recession was for families and businesses, it was equally as serious for Rhode Island's state and local governments. In the euphoria of the real estate boom of the late 1980's, spending decisions were made that depended upon one-time revenues and unsustainable annual revenue growth. When the economic cycle turned downward, Rhode Island's decision-makers faced a deficit of historic proportions. This fiscal emergency was addressed by a tax increase, which weakened our economic competitiveness, reduced funding for essential services, and postponed investments in the State's infrastructure.

It is difficult to conceive that only one short decade after the State's worst fiscal emergency since the Great Depression we again have committed to spending levels that we cannot afford and again may be witnessing the fiscal health of the Ocean State unravel. Since 1996 State spending has increased at nearly three times the rate of inflation, and has grown faster than the personal income of Rhode Island's citizens.

Today a series of factors, including new spending pressures, slower economic expansion, and the cost of necessary tax reforms are combining to create uncertainty about Rhode Island's future fiscal stability. For example, in FY 2004 the State's operating budget deficit is projected to equal 5.6% of available revenue, which is estimated to grow to 13.0% of revenues by FY 2007. Unless decision-makers demonstrate the political will to make the needed tough fiscal choices the opportunity to finance critically important public investments in our people and infrastructure may be put in harms way.

Even though the State's Five Year Finance Forecast includes over \$313.0 million in additional revenues from proposed securitization of tobacco proceeds, the forecast still projects an operating budget deficit of \$375.0 million by FY 2007. Therefore, the RIPEC Board of Directors believes that the Governor's FY 2003 Budget does not adequately address the State's fiscal needs. Over the past ten years, State decision-makers have made tough choices that have helped to enhance Rhode Island's economic competitiveness. If we are to sustain these gains as well as the ability to make strategic investments for the future, budget choices in the coming weeks should be equally as thoughtful.

Shivan S. Subramaniam, President
David A. Arpin
Bernard V. Buonanno
John D. Butler
Stephen J. Carlotti
Malcolm G. Chace
Donna C. Cupelo
Louise Durfee
Robert R. Fournier

Robert C. Halkyard
John D. Holmander
Robert E. Liguori
Frederick C. Lohrum
Albert W. Ondis
Kenneth A. Rathgeber
Donald J. Reaves
Michael F. Ryan
Thomas M. Ryan

Henry D. Sharpe, Jr.
Rev. Philip A. Smith, O.P.
Neil D. Steinberg
Thomas A. Taylor
Alfred J. Verrecchia
James R. Winoker
John Yena

FY 2003 State Budget Overview and Comments – Part I

RIPEC's analysis of the FY 2003 State Budget will be presented in three parts. Part I includes an overview of the Governor's FY 2002 Revised and FY 2003 Budget request along with RIPEC's Comments on the overall fiscal plan. Part II will discuss Medicaid and RITE Care in greater detail and Part III will review Rhode Island's debt and the proposed bond referenda questions.

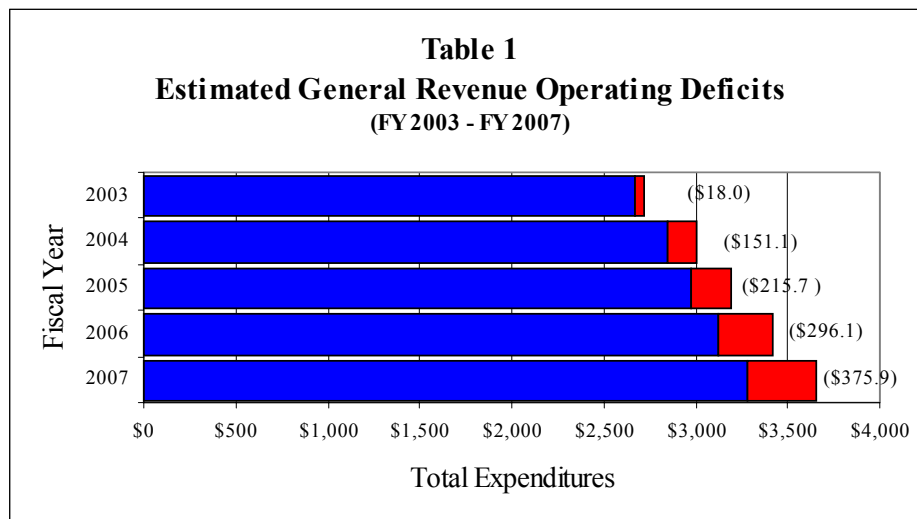
Highlights

1. The Governor has proposed a \$2,668.9 million in General Revenue expenditures to support State operations in FY 2003. This represents a 1.8 percent increase over the Governor's FY 2002 revised budget (\$2,625.0 million).
2. Approximately 42.0 cents of every new dollar spent since FY 1996 has been used to support direct grants and benefits to individuals – i.e. Medicaid, child care and programs for the disabled.
3. The five-year forecast estimates continued operating deficits of \$151.1 million in FY 2004 and increasing to \$375.9 million in FY 2007 – this includes approximately \$313.6 million in net new proceeds from the proposed tobacco securitization over this five-year period.
4. The Governor has proposed using \$99.2 million of the net tobacco securitization proceeds to balance the FY 2003 budget.
5. The Governor's budget eliminates \$62.0 million in State aid that would have been used to provide direct property tax relief.
6. Personnel expenditures are expected to increase to \$1,305.5 million – a 5.4 percent increase from FY 2002.
7. The average cost per FTE position will increase by 6.7 percent – increasing to \$66,654 per FTE position.

I. Overview of Spending Patterns in Rhode Island

Since FY 1996, the State has taken advantage of robust revenues to implement a number of programs. These include an income tax reduction program, begin the phase-out of inventory and motor vehicle property taxes, invest in school aid and infrastructure improvement initiatives, and enhance health care and child care for families and needy children. However, recent economic conditions have converged with slower revenue growth and increasing spending demands. Therefore, the Governor and the General Assembly face difficult fiscal decisions in the coming weeks in order to balance the budget and to ensure the State’s long-term fiscal health.

Based on the data in the Governor’s FY 2003 Budget, the Governor’s five-year projection through FY 2007 indicates an annual and expanding operating deficit. The forecast assumes revenues will grow at an average annual rate of approximately 2.3 percent while expenditures are projected to grow by 5.3 percent over the same period. The expenditure growth rate is more than twice the estimated annual rate of inflation (2.2 percent).



The State Budget Officer is projecting out-year deficits of \$151.1 million in FY 2004 (5.6 percent of available revenues) to \$375.9 million in FY 2007 (13.0 percent of available revenues). Although out-year estimates are only as accurate as the assumptions upon which they are predicated, the forecast provided raises a number of issues regarding the State’s future fiscal stability given the Governor’s FY 2003 budget proposals.

What is of concern is that while the Governor is anticipating operating deficits in each of the next five fiscal years (from \$18.0 million in FY 2003 to \$375.0 million in FY 2007), there are few provisions to permanently close this expected gap. As shown on Table 2, the Administration’s forecast assumes that the tobacco securitization proceeds will provide a total net increase in available resources to the State of \$313.6 million over the next five fiscal years.

As Table 3 shows, the FY 2003 budget (all funds) represents a \$1.1 billion increase from FY 1996 (adjusted to 2003 dollars) - a 25.4 percent increase over this period. Assuming the Governor's budget were adopted, expenditures supporting grants and benefits (programs providing direct support to individuals) would increase by \$457.1 million, representing 42.2 percent of the total growth in expenditures during this period

These programs include Medicaid, childcare and TANF as well as other income support programs administered by the State. The increase in managed care programs (RITE Care) of \$228.0 million represented one-fifth of the net increase in statewide spending during this period. FY 2003 RITE Care expenditures of nearly \$333.0 million essentially make up all of the State's expenditures in Managed Care. FY 2003 RITE Care related expenditures include the Governor's proposal to enroll SSI populations into the program.

Table 2
Impact of Proposed Tobacco Securitization on Five-Year Forecast

Fiscal Year	Governor's Proposed Securitization Program				
	Current MSA Payment	Residual MSA Payment	Debt Service Savings	General Purpose Funds	Estimated Net Proceeds
2003	\$54.3	\$0.0	\$43.9	\$55.3	\$153.5
2004	(47.0)	7.8	39.4	77.8	78.1
2005	(47.5)	7.9	38.8	53.3	52.5
2006	(48.1)	8.0	37.8	19.2	17.0
2007	(48.7)	8.1	33.1	20.0	12.6
Total	(\$136.9)	\$31.8	\$193.1	\$225.6	\$313.6

Source: RIPEC calculations based on Budget Office Data

There are several factors driving the level of expenditures for grants and benefits to individuals. Most recognize economic forces as well as socio-economic and demographic trends (i.e. income levels and age cohorts) play critical roles in the expenditure responsibilities of the State. In addition, policymakers constantly adjust, refine and expand programs based on policy shifts. For example, over the past couple of years, the State has expanded eligibility for state funded health care (Rite Care), pharmaceutical assistance and child-care. The Rite Care program

The second largest component of State budget growth has been in local aid. All local aid increased by \$348.0 million, representing a third of the net growth in the budget since FY 1996. Education aid has been the principal driver within local aid. Of the \$348.0 million net increase in local aid, nearly 42.0 percent has been due to increases in education aid. Education aid to local school districts represents 13.5 percent of the growth in total adjusted expenditures during this period.

The third largest factor in budget growth during this period is overhead costs. Of the \$1.1 billion in net expenditure growth from FY 1996 to FY 2003, approximately 16.3 percent (\$176.2 million) is attributable to personnel expenditures. Personnel costs include a 4.5 percent COLA adjustment for most State employees, requiring an additional \$44.5 million in funding. An additional 1.8 percent (\$19.9 million) of the growth is related to various operating expenditures. Therefore, nearly 18.1 percent of the growth in the State's total expenditure program proposed by the Governor is related to general overhead for State programs.

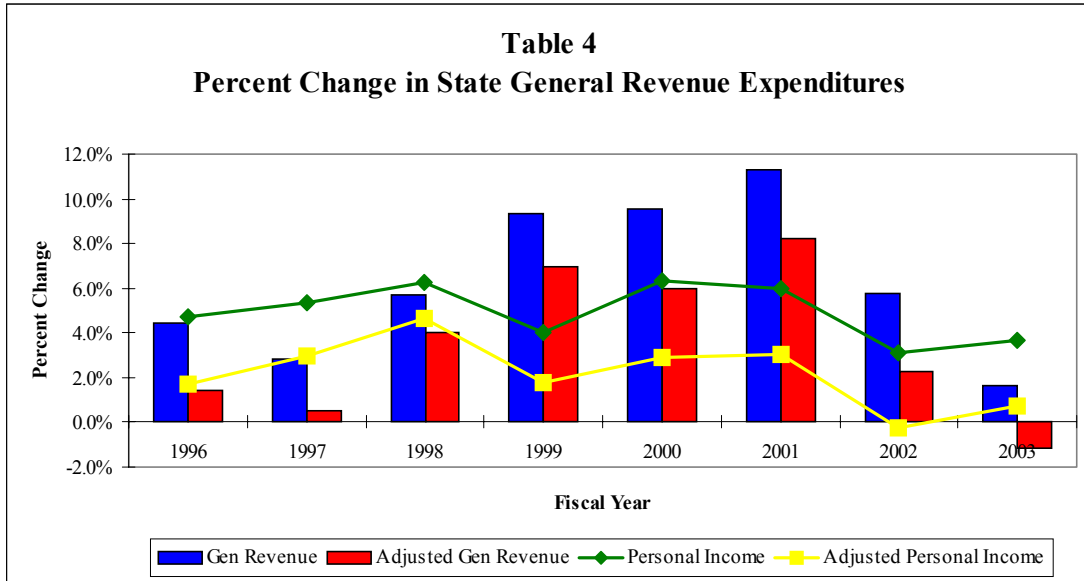
If one looks at general revenue growth as a whole, additional information can be derived. Table 4 displays unadjusted and inflation-adjusted (estimated 2003 dollars) percent changes in general revenue expenditures from FY 1996 – FY 2003. It also sets forth the estimated change in personal income in Rhode Island (both adjusted and unadjusted). Since FY 1996, the State's general revenue budget has grown at a faster rate than inflation and personal income.

**Table 3
Rhode Island State Budget Drivers - All Funds (Adjusted for Inflation)**

Expenditure Category	FY 1996 Actual	% of Total	FY 2003 Proposed	% of Total	Increase	Share of Increase
General Operations						
Personnel	\$1,113.6	26.1%	\$1,289.8	24.1%	\$176.2	16.3%
Operations	338.6	7.9%	358.6	6.7%	20.0	1.8%
Subtotal - Operations	\$1,452.3	34.1%	\$1,648.4	30.8%	\$196.2	18.1%
Grants & Benefits						
Income Support (TDI & Employ)	\$337.8	7.9%	\$335.0	6.3%	(\$2.8)	-0.3%
Medical Assistance - Mgd Care	106.6	2.5%	334.6	6.3%	228.0	21.1%
Medical Assistance - All Other	603.1	14.2%	629.2	11.8%	26.1	2.4%
Development Disabilities	119.0	2.8%	170.2	3.2%	51.2	4.7%
Child Welfare	70.7	1.7%	102.3	1.9%	31.6	2.9%
TANF	154.5	3.6%	85.1	1.6%	(69.4)	-6.4%
Child Care	19.3	0.5%	68.5	1.3%	49.2	4.5%
SSI	23.6	0.6%	30.7	0.6%	7.1	0.7%
RIPAE	8.2	0.2%	13.3	0.2%	5.2	0.5%
Other Grants & Benefits	430.8	10.1%	561.8	10.5%	131.0	12.1%
Subtotal - Grants & Benefits	\$1,873.6	44.0%	\$2,330.7	43.6%	\$457.1	42.2%
Local Aid						
Education Aid	\$541.7	12.7%	\$687.4	12.9%	\$145.7	13.5%
Motor Vehicle Phase-out	0.0	0.0%	86.5	1.6%	86.5	8.0%
General Revenue Sharing	15.4	0.4%	48.3	0.9%	32.9	3.0%
Other	77.6	1.8%	160.4	3.0%	82.8	7.7%
Subtotal - Local Aid	\$634.7	14.9%	\$982.6	18.4%	\$348.0	32.2%
Capital Expenditures						
Capital Expenditures	\$91.3	2.1%	\$238.8	4.5%	\$147.5	13.6%
Debt Service	210.5	4.9%	143.9	2.7%	(66.6)	-6.2%
Subtotal - Capital	\$301.8	7.1%	\$382.6	7.2%	\$80.9	7.5%
Total	\$4,262.3	100.0%	\$5,344.4	100.0%	\$1,082.1	

Source: RIPEC calculations based on State Budget Data - State Budget Office, DOA (Expressed in 2002 dollars)

FY 2003 general revenue expenditures are expected to represent an increase of 1.7 percent from FY 2002 revised expenditures, whereas inflation is expected at 2.9 in FY 2003. The FY 2003 general revenue budget would actually represent a 1.2 percent decline in real terms from FY 2002 revised appropriations (adjusted to 2003 dollars). This is a marked change from the growth rates in recent budgets where general revenue spending was exceeding inflation and personal income growth.



II. The Governor’s FY 2002 Revised and FY 2003 Budget

Proposed FY 2002 Revised - The Governor has proposed a \$5,250.3 million budget for FY 2002. While the FY 2002 enacted budget represented a 7.1 percent increase (\$345.0 million) from FY 2001, the Governor’s revised budget represents an 8.5 percent (\$410.5 million) increase from FY 2001. Of the \$410.5 million increase, \$142.4 million (35.0 percent) is in general revenues, \$162.9 million (40.0 percent) is in federal funds and the \$105.2 million balance (25.0 percent) is the net increase in restricted and other funds.

While the overall change in the budget is important, the following concentrates on the changes to the State’s General Revenue Budget. The Governor proposes a net decrease of \$25.8 million from the FY 2002 enacted general revenue budget (1.0 percent decrease). General revenue appropriations for overhead (personnel and operating) are proposed to increase by \$13.4 million, while local aid is reduced by \$24.5 million and capital expenditures are reduced by \$21.3 million. Grants and benefits to individuals are proposed to increase by \$6.4 million. There are a number of proposed changes to the FY 2002 General Revenue Budget worth noting.

The Governor has proposed to:

- Permanently freeze the motor vehicle excise tax phase out at the current level of exemption (\$3,500 of value) – this would require rolling back the advance reimbursement appropriated in the FY 2002 enacted budget - resulting in an estimated savings of \$30.1 million to the State;
- Delay a number of capital projects and asset protection initiatives totaling \$17.4 million that were to be funded through the Rhode Island Capital Fund;

- Eliminate the \$4.5 million appropriation for affordable housing (subsequently proposed to fund through a revenue bond through Rhode Island Housing);
- Shift the funding (\$4.0 million) for the development of a Legislative Office Building from a general revenue appropriation to the Rhode Island Capital Fund in FY 2004; and
- Restore the \$4.0 million in personnel savings originally built into the FY 2002 enacted budget to be achieved through attrition.

Table 5
State Expenditures - All Funds

By Category	1996	1997	1998	1999	2000	2001	2002	2003
Personnel	\$927.4	\$929.8	\$959.5	\$1,023.6	\$1,089.3	\$1,157.7	\$1,224.0	\$1,289.8
Operating	282.0	312.6	313.7	338.1	402.0	432.6	364.6	358.6
Local Aid	528.5	562.3	582.8	677.7	773.9	865.2	939.7	982.6
Grants & Benefits	1,560.4	1,577.7	1,633.9	1,754.3	1,858.7	2,036.7	2,295.5	2,330.7
Capital	76.0	57.5	45.6	136.9	142.5	174.1	245.7	238.8
Debt Service	175.3	184.2	187.4	199.3	159.3	173.5	180.7	143.9
<i>Total</i>	<i>\$3,549.6</i>	<i>\$3,624.0</i>	<i>\$3,723.0</i>	<i>\$4,129.8</i>	<i>\$4,425.9</i>	<i>\$4,839.8</i>	<i>\$5,250.3</i>	<i>\$5,344.4</i>
By Fund	1996	1997	1998	1999	2000	2001	2002	2003
General Revenues	\$1,713.5	\$1,762.5	\$1,862.5	\$2,036.3	\$2,230.6	\$2,482.6	\$2,625.0	\$2,668.9
Federal Funds	1,037.8	1,079.2	1,062.8	1,231.1	1,283.0	1,429.0	1,591.9	1,616.5
Restricted Funds	104.4	103.1	127.9	130.7	144.0	95.5	113.4	134.9
Other Funds	694.0	679.3	669.7	731.7	768.3	832.7	920.0	924.1
<i>Total</i>	<i>\$3,549.7</i>	<i>\$3,624.0</i>	<i>\$3,723.0</i>	<i>\$4,129.8</i>	<i>\$4,425.9</i>	<i>\$4,839.8</i>	<i>\$5,250.3</i>	<i>\$5,344.4</i>
<i>Percent Change</i>		<i>2.1%</i>	<i>2.7%</i>	<i>10.9%</i>	<i>7.2%</i>	<i>9.4%</i>	<i>8.5%</i>	<i>1.8%</i>
Adjusted Expenditures	\$4,262.3	\$4,254.0	\$4,303.1	\$4,670.2	\$4,842.2	\$5,148.6	\$5,402.3	\$5,344.4
<i>Percent Change</i>		<i>-0.2%</i>	<i>1.2%</i>	<i>8.5%</i>	<i>3.7%</i>	<i>6.3%</i>	<i>4.9%</i>	<i>-1.1%</i>

Source: RIPEC calculations based on State Budget Office Data and Bureau of Labor Statistics (reflected in 2003 dollars)

FY 2003 Budget Summary - The Governor has proposed a \$5,344.4 million budget to support State operations in FY 2003. As measured against the budget originally enacted for FY 2002 (\$5,184.8 million), FY 2003 appropriations represent an increase of \$159.6 million, or 3.1 percent. As shown on Table 1, total FY 2003 expenditures are proposed to increase by 1.8 percent (\$94.1 million) over the Governor's FY 2002 revised budget (\$5,250.3 million). General revenue expenditures are budgeted at \$2,668.9 million, which represents a \$18.1 million increase (less than 1.0 percent) from FY 2002 enacted budget, and \$43.9 million more (1.8 percent) than the Governor's FY 2002 revised request.

Table 6 shows the State's Budget Statement from FY 2000 through FY 2003. The State has experienced a surplus in each of the past three fiscal years displayed. In FY 2000, the \$114.4 million opening surplus represented 5.0 percent of estimated ongoing revenues. In FY 2003, the \$18.2 million opening surplus represents approximately 1.0 percent of the total on-going operating revenues. The availability of an opening surplus has been critical in balancing the budget for the past several fiscal years.

Source of Funds: General revenues represent unrestricted resources the State generates through taxes, fees and other sources. General revenues represent approximately 50.0 percent of the State budget. Federal funds represent about 30.0 percent of the State's budget. Federal Medicaid payments account for nearly half of all federal fund expenditures.

Other funds, totaling \$924.1 million in FY 2003, is primarily made up of university and college funds and employment and training funds, represent about 17.0 percent of the FY 2003 budget. Restricted funds of \$134.9 million in FY 2003 represent the smallest resource to the State – 3.0 percent of all resources. These funds include a range of fees and charges dedicated to specific programs and activities.

**Table 6
Budget Statement**

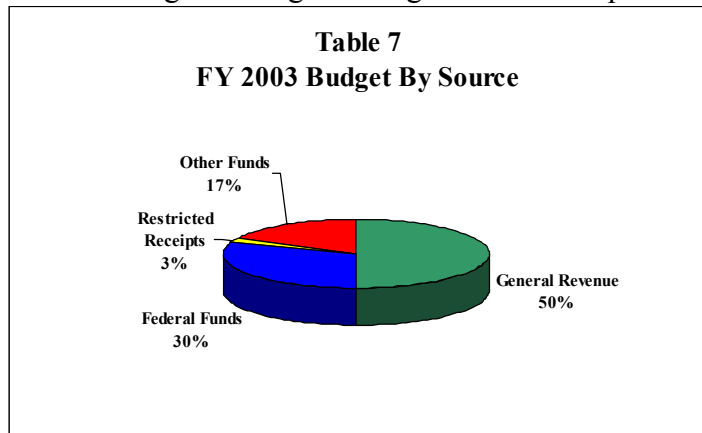
Summary	FY 2000	FY 2001	FY 2002	FY 2003
Opening Surplus	\$98.3	\$91.9	\$132.1	\$18.2
Reappropriated Surplus	16.1	21.7	11.1	-
Total - Opening Surplus	\$114.4	\$113.7	\$143.1	\$18.2
Revenues				
Enacted	\$2,277.3	\$2,565.2	\$2,574.0	\$0.0
Nov Estimating Conference	-	-	(35.7)	2,517.5
Governor Changes	-	-	15.5	187.9
Total Revenues	\$ 2,277.3	\$ 2,565.2	\$ 2,553.8	\$ 2,705.4
Cash Stabilization	(47.5)	(53.1)	(53.7)	(54.5)
Total Available Revenues	\$ 2,344.2	\$ 2,625.8	\$ 2,643.2	\$ 2,669.2
Expenditures	\$ 2,230.6	\$ 2,482.6	\$ 2,625.0	\$ 2,668.9
Free Surplus	91.9	132.1	18.2	0.2
Reappropriations	21.7	11.1	-	-
Total Ending Balance	\$113.7	\$143.1	\$18.2	\$0.2

Source: RIPEC Calculations based on FY 2003 Budget Data

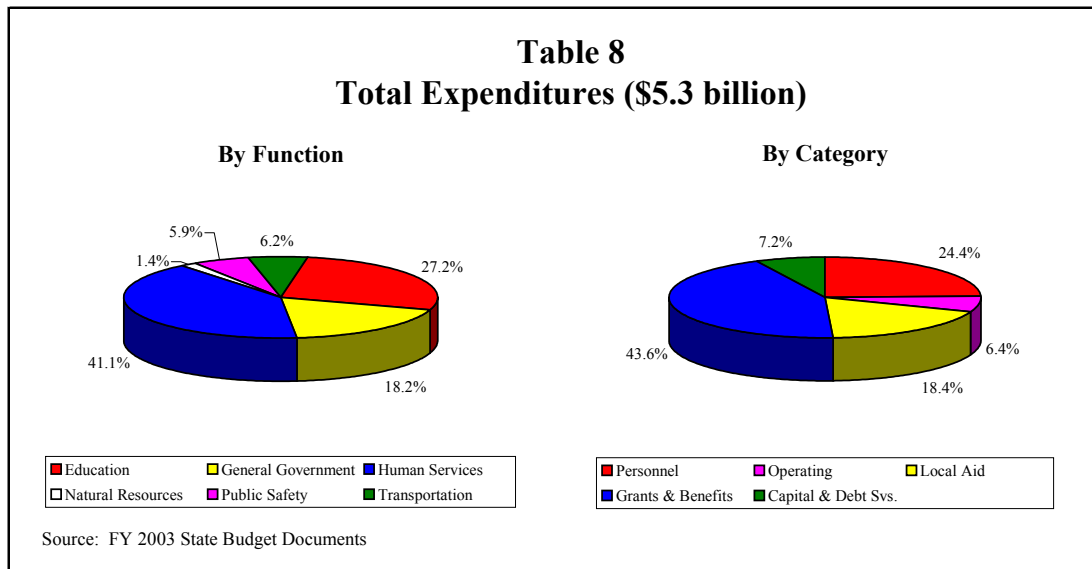
Expenditure by Function: FY 2003 expenditures of \$2,194.4 million for human service programs represent the largest portion of State expenditures (41.1 percent). Human services include expenditures for the Temporary Assistance to Needy Families Program (TANF), Medicaid, Supplementary Security Income (SSI) and other income assistance programs. The \$1456.1 million budgeted for education programs represent 27.2 percent of the total Budget. Approximately \$615.8 million of this amount is the proposed level of direct education aid to local school districts funded through general revenues.

FY 2003 expenditures of \$972.0 million would support the general government function, which includes agencies providing general administrative services to taxpayers and other State agencies. Most of these expenditures are for employment and training programs, including unemployment compensation. The FY 2003 budget for general government represents approximately 18.2 percent of total FY 2003 expenditures. The remaining \$721.9 million in FY 2003 State expenditures would support transportation, public safety, and natural resources.

Expenditure by Category: There are five major categories of expenditures - personnel, operating, local aid, grants and benefits and capital expenditures. Grants and benefits, which include



medical assistance, temporary disability payments and other cash assistance, constitutes the largest category of expenditures, representing 43.6 percent (\$2,330.7 million) of the total budget. Personnel expenditures of \$1,305.5 million represent 24.4 percent of the State's budget, and general operations expenditures of \$342.9 million represent an additional 6.4 percent. Local aid, which includes education aid and other direct assistance to municipalities, represents 18.4 percent (\$982.6 million) of the budget. The remaining 7.2 percent of the budget is dedicated to capital and debt service expenditures.



The following highlights selected expenditure and program changes. The Governor has proposed to:

State Aid

- Permanently freeze the program to eliminate the excise tax on motor vehicles at the \$3,500 exemption, which would result in an estimated \$54.1 million savings to the State;
- Freeze general revenue sharing at the FY 2002 percentage (2.4 percent) rather than the 2.7 percent under current law – for an estimated saving to the state of \$6.0 million;
- Reduce the Payment in Lieu of Taxes program by appropriating resources that would provide 24.8 percent of property taxes not collected on exempt properties rather than the 27.0 percent required under current law – for an estimated \$1.6 million in savings to the State;
- Increase the revenues generated by the Public Service Corporation Tax by \$6.7 million by modifying the method of levying the tax on telecommunication companies’ property; and
- Increase direct state aid to local school districts by \$19.8 million, targeting the funds to urban districts while guaranteeing a 1.0 percent increase per school district.

Grants and Services to Individuals

- Revise RITE Care program, requiring health plans to include the full continuum of behavioral medical services, including inpatient care for foster children, enrolling foster care and SSI children in RITE care and restructuring reimbursement rates for neonatal intensive care services (total estimated savings of \$10.0 million);
- Continue to freeze the income eligibility for childcare at 225 percent of the federal poverty level – it is programmed to increase to 250 percent of poverty – resulting in an estimated savings of \$1.3 million;
- Eliminate the State-funded food stamp program for immigrants. The Governor has built a \$1.2 million savings in the budget in anticipation of the Federal Government reinstating eligibility for immigrants for the Federal food stamp program;
- Restructure pharmacy benefits for all Medicaid enrollees through a tiered formulary and requiring prior authorization for certain drugs. The State is expected to experience a \$3.0 million savings in general revenue from this initiative;
- Increase the minimum work requirement from 20 to 30 hours for adult participants with no children younger than six in the Family Independence Program (FIP), which provides cash assistance to needy families and children; and

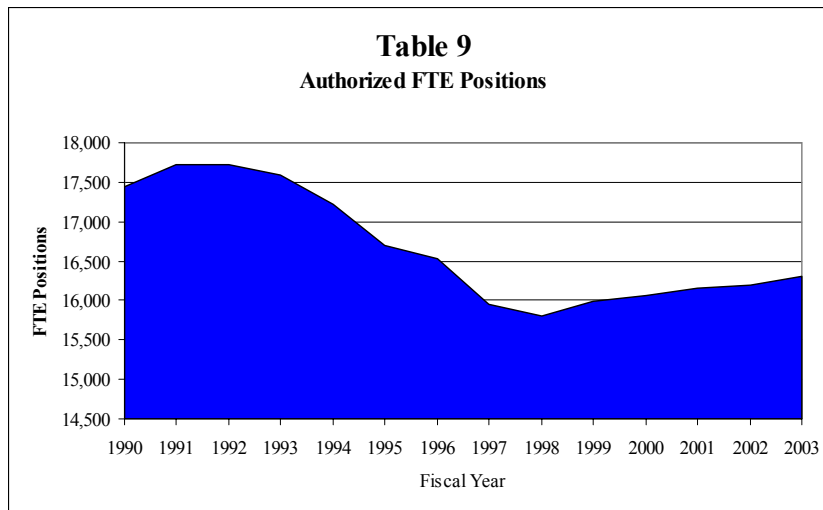
Other

- Expand the probation and parole programs at the Department of Corrections to provide community based supervision with lower caseloads. The annual cost of the additional 18.0 FTE positions is approximately \$1.5 million;
- Include a \$5.9 million appropriation for a retroactive pay agreement with the Rhode Island Brotherhood of Correctional Officers – The FY 2003 appropriation would represent the second of three installments for the retroactive increases for current and former employees;
- Create a new class of State employee that would be exempt from the current FTE position authorization process. According to Article 38 of the proposed budget, these positions would not be considered State employees.

Personnel Trends – The State allocates FTE positions (full time equivalent positions) to all agencies and departments. These FTE positions now exclude certain positions in higher education that are research oriented and are financed through federal or other third party sources. However, the following includes these positions in the totals for comparison purposes.

The Governor's FY 2002 revised budget request includes 16,191.7 FTE positions, representing a 5.0 FTE position increase from the FY 2002 enacted budget. This figure includes 335.4 FTE positions in higher education that have been designated as exempt from the enacted FTE authorizations. The 5.0 FTE position increase was in the designated exempt positions.

The Governor's FY 2003 budget includes 16,304.7 FTE positions, representing a 113.0 position increase from his FY 2001 revised budget. Of the increase, 107.3 positions were related to additional higher education exempt positions, increasing the number of exempt positions to 442.7 FTE positions. The remaining 5.7 FTE position net increase was principally for additional positions in the Department of Corrections. It should be noted that as of the pay period ending March 9, 2002, State government had 15,325.0 FTE positions filled. If this is compared to FY 2002 enacted budget (15,856.0 positions – not including higher education excluded positions), the State has approximately 531.0 FTE positions currently vacant.



FY 2002 revised personnel expenditures total \$1,238.6 million. This includes all related employee salaries and benefits as well as contracted services, such as the 4.0 percent COLA for all state employees. The Governor's FY 2002 Revised personnel Budget represents a \$9.9 million net increase in personnel spending from the FY 2002 Enacted Budget. This is due to an additional net increase in overtime expenditures of \$4.8 million and an additional \$10.2 million in consultant expenditures. Based on 16,191.7 funded FTE positions, the average cost per FTE is \$62,432. The average cost per FTE position is net of several anticipated actions related to direct compensation, such as contracted cost-of-living adjustments, adjustments for incentives and longevity, and proposed statewide turnover savings of \$31.2 million.

FY 2003 personnel expenditures total \$1,305.5 million, a \$67.0 million (5.4 percent) increase from the FY 2002 revised personnel budget. The increase includes the 4.5 percent COLA provided for in the State's labor contracts (\$44.5 million) as well as an additional \$16.7 million for additional health care insurance costs. Based on 16,304.7 funded FTE positions, the average cost per FTE is \$66,656 – an increase of 6.8 percent. Again, the average cost per FTE position is net of several anticipated actions related to direct compensation and proposed statewide turnover savings of \$34.3 million.

General revenues support approximately 55.0 of all personnel expenses in FY 2003. Federal Fund support nearly 23.0 percent and the remaining funds (special funds, restricted receipts and internal service funds) would remain essentially the same, supporting 22.0 percent of the personnel budget.

Table 10
State Personnel Costs

Personnel Costs (Millions)	FY 1999 Actual	FY 2000 Actual	FY 2001 Actual	FY 2002 Revised	FY 2003 Proposed	<i>FY 2003 - FY 2002 Revised</i>	
						Actual Change	Percent Change
Salaries & Benefits							
Net Salaries	\$603.3	\$633.5	\$662.6	\$721.6	\$760.4	\$38.8	5.4%
Overtime	47.9	47.1	57.0	51.7	49.5	(2.2)	-4.2%
Retirement	62.1	59.6	60.7	52.3	67.5	15.2	29.0%
Medical	81.2	96.9	106.4	112.0	132.5	20.5	18.3%
Other Benefits/Payroll Costs	61.6	65.6	68.3	73.3	76.9	3.6	4.9%
<i>Salaries & Benefits</i>	<i>\$856.0</i>	<i>\$902.6</i>	<i>\$954.9</i>	<i>\$1,010.9</i>	<i>\$1,086.8</i>	<i>\$75.9</i>	<i>7.5%</i>
Funded FTE Positions	15,986.6	16,072.3	16,161.7	16,191.7	16,304.7	113.0	0.7%
Average Cost Per FTE	\$53,545	\$56,160	\$59,085	\$62,432	\$66,656	\$4,224	6.8%
Other Personnel Costs							
Other Payroll Costs	\$79.2	\$83.5	\$85.8	\$88.9	\$87.0	(\$1.9)	-2.2%
Purchased Services	100.8	116.6	131.2	138.8	131.8	(7.0)	-5.1%
<i>Other Personnel</i>	<i>\$180.0</i>	<i>\$200.1</i>	<i>\$217.0</i>	<i>\$227.6</i>	<i>\$218.7</i>	<i>(\$8.9)</i>	<i>-3.9%</i>
Total Personnel Costs	\$1,036.0	\$1,102.7	\$1,172.0	\$1,238.5	\$1,305.5	\$67.0	5.4%

Source: State Budget Office and FY 2003 Personnel Supplement.

The Governor's budget proposes to create a new class of positions called limited service positions. These positions would not be subject to the FTE position authorization spelled out in the annual appropriations bill. According to Article 38 of the Governor's proposed budget, these positions would be funded by non-general revenue sources of revenue and would be limited to one year of employment. These positions would not be eligible for retirement, health or other benefits ordinarily provided to state employees.

There are two additional personnel budget issues worth highlighting. First, the State's expenditures for overtime display interesting trends. For example, overtime expenditures have increased from approximately 5.5 percent of net salaries in FY 1996 to 7.3 percent in FY 2001. While the FY 2001 enacted budget included \$38.4 million in overtime expenditures, the FY 2001 actual experience totaled \$57.0 million. Therefore, the State spent nearly 50 percent more than was budgeted for overtime in FY 2001. Similarly, the FY 2002 enacted budget included \$46.9 million in overtime, whereas the Governor's FY 2002 revised budget includes \$51.7 million in net overtime expenditures. The Governor's FY 2003 proposed budget includes \$49.5 million in net overtime expenditures.

A similar budgeting pattern emerges in purchased services – or contracted services to the State. Purchased services expenditures were 9.5 percent of total personnel expenditures in FY 1996. This has since increased to 11.2 percent in FY 2001. The FY 2001 enacted budget included \$114.2 million in purchased service expenditures. Actual FY 2001 experience was \$131.2 million – nearly 15.0 percent more than originally budgeted. Similarly, in FY 2002, the budget

as enacted included \$128.6 million in contract spending while the Governor has requested \$138.8 million in spending for these services – a \$10.2 million net increase from the enacted budget. The Governor’s FY 2003 budget request includes \$131.8 million in expenditures for contracted services.

Revenue Plan – The Governor’s FY 2002 revised budget and FY 2003 proposed budget are based on revenue estimates established last November. It should be noted that the November 2001 Revenue Estimating Conference (REC) lowered FY 2002 revenue estimates by \$35.7 million – from \$2,574.0 million to \$2,538.3 million. The decrease was principally a function of the slower growth in personal income tax receipts than originally anticipated.

While FY 2003 revenue projections (\$2,517.5 million) reflected a net decline of \$20.7 million from revised FY 2002 revenue estimates, they did not include the Hospital Licensing Fee, which has been extended each year by the Governor and General Assembly. As shown below the Governor did recommend continuing the Hospital Licensing Fee. Therefore, anticipated revenues (including the hospital licensing fee) are estimated to represent an increase of nearly \$30.0 million.

Proposed Changes	FY 2002	FY 2003
Personal Income Tax	\$ -	\$ (81.0)
Sales Tax - Cigarettes	-	1,471.8
Cigarette Tax	-	21,026.0
Hospital License Fee	-	59,994.4
Other Licenses & Fees	367.3	6,127.5
Sales and Services	1,162.9	2,219.5
Departmental Receipts	3,084.0	1,825.1
Video Lottery Terminal Income	7,173.4	24,262.9
Sinking Fund	518.0	6,573.0
DEPCO Proceeds	500.0	4,000.0
MHRH 2001 Audit Adjustment	2,689.5	-
Resource Recovery Transfer	-	4,000.0
Gas Tax Transfer	-	1,175.0
Tobacco Settlement Securitization		55,300.0
Total	\$ 15,495.1	\$ 187,894.1

Source: FY 2003 Budget - Executive Summary

The Governor has proposed changes to the revenue plan for both fiscal years. The Governor’s proposed FY 2002 changes total \$15.5 million. These changes include:

- \$7.2 million in additional video lottery terminal income by eliminating the portion (6.0 percent) of net terminal income that is currently allocated to dog kennel owners at Lincoln Park and decreasing both Lincoln Park’s and Newport Jai Alai’s shares from 31.0 to 28.0 percent;
- \$4.6 million in additional revenues from increased fees (effective May 2002), reimbursements for various services, and a number of departmental revenues;
- \$1.0 million in transfers from the sinking fund to the general fund; and
- \$2.7 million audit adjustment for the Department of Mental Health, Retardation & Hospitals.

The Governor’s FY 2003 changes total \$187.9 million. These changes include:

- \$55.3 million would be generated from the securitization of the tobacco proceeds (discussed below);
- \$22.5 million from a \$0.35 increase in cigarette taxes;

- \$60.0 million in the continuation of and increase in the Hospital Licensing Fee (rate increases from 4.25 to 4.48 of gross patient service revenues);
- \$24.3 million in additional video lottery terminal income;
- \$10.6 million in transfers from sinking fund proceeds to the general fund;
- \$4.0 million in funds transferred from the Resource Recovery Corporation; and
- \$11.2 million through various fee increases and the delay of the last 0.25 cents transfer of the gasoline tax to the Department of Transportation.

Tobacco Securitization Proposal: A critical component of the Governor’s overall budget plan is the proposed securitization of the tobacco proceeds. Given that the FY 2003 budget includes a total of approximately \$153.5 million in total tobacco settlement-related funds (\$54.3 million in Master Settlement Agreement Proceeds and \$99.2 million in resources related to securitization), additional details are warranted.

In November 1998, 46 states (including Rhode Island), Puerto Rico, the U.S. Virgin Islands and others signed the Master Settlement Agreement (MSA) with the principle domestic tobacco manufacturers. The agreement results in payments to participants in perpetuity. The payments are subject to certain adjustments, including volume of cigarette sales and annual inflation.

The Governor proposes to sell the State’s right to the next 40 years’ worth of payments to an entity to be created. This entity would have the single purpose of issuing bonds and repaying the bonds with future tobacco settlement revenues. The proposal is designed to have the new entity repay the 40-year bonds in 26 years – by 2029. This is referred to as a modified turbo amortization program to retire debt. A full turbo amortization program would result in full payment by FY 2022 (where 100 percent of available tobacco payments are used to repay the bonds with no residual).

With this sale of payments, the State is able to generate proceeds based on future settlement payments and to transfer the relative risk from the State (i.e. volume adjustments, lawsuits and other) to the capital market.

The Governor’s proposal would represent a total sale of \$602.5 million. The State would net approximately \$495.0 million due to establishing a debt service reserve account, cost of issuance and original issue discount as well as capitalized interest (needed in order to delay the first debt service payments to FY 2004).

The Governor’s plan for the \$495.0 million in net proceeds include defeasing approximately \$272.2 million in existing, non-callable general obligation debt (thereby freeing up \$324.7 million in net debt service payments through FY 2012). This will permit the State to shift the general revenue appropriations allocated for debt service on these bonds to other purposes. In FY 2003, the savings are expected to yield \$43.9 million. The Governor programs the \$232.6

Issuance	\$602.5
Original Issue Discount	(\$3.1)
Cost of Issuing Bonds	(6.0)
Liquidity Reserve Account	(45.4)
Capitalized Interest Fund	(53.2)
Proposed Debt Defeasance	(272.2)
General Use/Grant Funds	(232.6)
Interest Earning on Proceeds	10.2
Total Expenditure	(\$602.5)
Source: RIPEC calculations and State Budget Office Data	

million balance as resources for general expenditure in the State's operating budget, beginning with \$55.3 million in FY 2003.

The Governor’s plan does not pledge the MSA payment for FY 2003 (\$54.3 million). Therefore, the State will keep these resources in the FY 2003 operating budget. Therefore, the State is required to establish a capitalized interest fund of \$53.2 million as part of the cost of issuing the bonds. The proposal does not pledge the Strategic Contribution Fund that occurs from FY 2008 through FY 2017. Given that the Governor’s plan does not pledge the entire amount of MSA payments through the bond repayment period, the balance (residuals) are returned to the State and can be used in the operating budget.

Table 13
Impact of Proposed Tobacco Securitization on
Current Master Settlement Agreement Provisions

Fiscal Year	Current MSA Payment	Governor's Proposed Securitization Program					Estimated Net Proceeds
		Strategic Contribution Fund	Residual MSA Payment	Debt Service Savings	General Purpose Funds		
2003	\$54.3	-	\$54.3	\$43.9	\$55.3	153.5	
2004	47.0	-	7.8	39.4	77.8	78.1	
2005	47.5	-	7.9	38.8	53.3	52.5	
2006	48.1	-	8.0	37.8	19.2	17.0	
2007	48.7	-	8.1	33.1	20.0	12.6	
2008	59.3	9.0	8.4	40.6	7.0	5.6	
2009	60.1	9.1	8.5	34.8	-	(7.7)	
2010	60.9	9.3	6.3	29.1	-	(16.2)	
2011	61.8	9.4	6.4	20.1	-	(25.9)	
2012	62.6	9.5	6.9	7.0	-	(39.2)	
2013	63.4	9.7	7.4	-	-	(46.3)	
2014	64.2	9.8	8.3	-	-	(46.1)	
2015	65.0	9.9	9.5	-	-	(45.6)	
2016	65.8	10.0	9.7	-	-	(46.1)	
2017	66.7	10.2	10.6	-	-	(45.9)	
2018	64.0	-	13.2	-	-	(50.8)	
2019	64.8	-	14.2	-	-	(50.6)	
2020	65.6	-	14.8	-	-	(50.9)	
2021	66.5	-	15.8	-	-	(50.7)	
2022	67.4	-	16.3	-	-	(51.0)	
2023	68.3	-	17.3	-	-	(50.9)	
2024	69.2	-	18.3	-	-	(50.9)	
2025	70.2	-	19.7	-	-	(50.5)	
2026	71.2	-	20.8	-	-	(50.4)	
2027	72.2	-	22.1	-	-	(50.1)	
2028	73.2	-	22.7	-	-	(50.5)	
2029	74.3	69.3	0.0	45.4	0.0	40.4	
2030	75.4	75.4	-	-	-	-	
2031	76.5	76.5	-	-	-	-	
2032	77.6	77.6	-	-	-	-	
2033	78.7	78.7	-	-	-	-	
2034	79.8	79.8	-	-	-	-	
2035	81.0	81.0	-	-	-	-	
2036	82.0	82.0	-	-	-	-	
2037	83.2	83.2	-	-	-	-	
2038	84.4	84.4	-	-	-	-	
2039	85.6	85.6	-	-	-	-	
2040	86.8	86.8	-	-	-	-	
2041	88.0	88.0	-	-	-	-	
2042	89.2	89.2	-	-	-	-	
2043	90.4	90.4	-	-	-	-	
Total	\$2,860.7	\$1,323.7	\$363.3	\$370.1	\$232.6	(\$516.7)	

Notes: Assumes Liquidity Reserve returned in 2029

Source: RIPEC Calculations based on State Budget Office Documents

III. RIPEC Comments

In light of an economic downturn and various spending pressures, the Governor was required to propose a fiscal plan that reflected some tough choices in prioritizing State spending. Indeed, setting clear priorities and understanding their impact on programs becomes increasingly important when state resources decline or demonstrate slower than anticipated growth. RIPEC supports a number of proposals in the Governor's FY 2003 proposed budget including:

- Increasing the Cigarette Tax;
- Targeting school aid to urban communities;
- Delaying expansion of eligibility for child care subsidies;
- Initiatives to help control the costs of medical assistance programs; and
- Enhancing probation and parole programs.

However, the test of fiscal soundness of any budget plan is whether current resources are adequate to support current operating costs, whether current obligations are realistically funded and whether revenues are realistically projected.

The Governor should be commended for proposing a FY 2003 budget that grows by less than 2.0 percent and holds the line on the number of authorized FTE positions. However, RIPEC is troubled by the way in which the Governor proposes to balance the FY 2003 budget and its impact on the long-term fiscal health of the State and its localities.

For example, the FY 2003 State budget is balanced by deferring costs into subsequent fiscal years, as evidenced by the health insurance contract for state employees, as well as dependence on a number of one-time revenues sources, which the Senate Fiscal Staff estimates to total \$43.1 million (excluding continuing the Hospital Licensing Fee). Furthermore, the FY 2003 Budget does not include economies resulting from changes in the structure of State government that would permanently reduce operating expenses. In the area of personnel, for example, costs are projected to increase by \$67.0 million – or 5.4 percent, and the average cost per FTE position is expected to increase 6.7 percent.

In preparing the FY 2003 State budget, the Administration identified a \$323.5 million “budget problem” – approximately 10.0 percent of the state's general revenue budget. To address this budget gap, the Governor's FY 2003 proposed budget includes almost \$188.0 million in net new revenue and \$135.0 million in net savings from various reductions in spending, principally reflected in reductions in state aid and property tax relief initiatives. RIPEC estimates that the Governor's FY 2003 proposed budget would reduce direct state aid to municipalities by approximately \$62.0 million based on current law. This does not include the additional \$6.0 million in aid that would occur if the Governor's modifications to the public service corporations tax were enacted. In RIPEC's opinion, the Governor's proposal to balance the FY 2003 budget is disproportionately based on reducing state aid programs. A possible consequence is an increase in local property taxes in many of Rhode Island's 39 cities and towns.

Bottom line, even with the dramatic cuts in state aid and the securitization of tobacco proceeds, the Administration's FY 2003 budget does not fundamentally address the projected ongoing structural budget gap, which is projected to be \$151.0 million in FY 2004 based on the Governor's FY 2003 fiscal plan. The operating deficit is projected to climb to \$375.9 million by FY 2007. As noted earlier in the report, the five-year forecast includes \$313.6 million in additional net revenues to support spending through the securitization of the tobacco proceeds.

RIPEC recognizes that the State has the difficult task of balancing crucial investments and containing costs. However, the proposed FY 2003 budget does contain some fiscal policy issues that RIPEC believes require additional consideration prior to enactment. These include:

- Tobacco Securitization;
- Personnel Issues;
- State aid and Property Tax Relief;
- Education Aid; and
- Debt Policies and Use of COPS;

Tobacco Securitization: Tobacco securitization would allow the State to obtain funds that can be used in the current year in exchange for revenues that would have been received in the future. The Governor's FY 2003 fiscal plan proposes to include \$153.5 million in net tobacco proceeds to balance the budget. This includes \$54.3 million in revenue from the tobacco master settlement agreement and \$99.2 million in resources made available due to the securitization of future tobacco revenue. The Governor's FY 2004 through FY 2007 forecast includes an additional \$160.1 million in revenues related to securitizing tobacco revenues. Is this a good deal for Rhode Island taxpayers? The answer to this question can be found in the way the securitization plan is structured and how the proceeds will be used.

The cost of securitization should be viewed in two parts. The first is the cost of issuance, including funds that will be needed to satisfy bondholder requirements (liquidity reserve and capitalized interest fund). Issuance costs will reduce monies available to the State from the tobacco securitization proceeds by \$107.7 million – reducing net proceeds from \$602.5 million to \$495.0 million. The second cost is the time value of money. The Governor estimates that the present value of the securitization proposal will cost about \$83.5 million when the present value of money is taken into consideration. These transaction costs do not appear to be unreasonable.

An issue that will need to be considered if the State pursues tobacco securitization is the potential impact of other state decisions to secure their tobacco settlement proceeds. Timing may be a factor given the potential for some market saturation of other state efforts. For example, both New Jersey and Wisconsin are expected to go to the market to support FY 2003 budgets with \$1.5 billion in tobacco bonds each. California is considering going to the market with more than \$4.0 billion in tobacco bonds (it is likely that California will go to the capital market with two separate tobacco bond proposals totaling \$4.0 billion). Other state actions can therefore adversely affect the demand and costs of Rhode Island's issuance of tobacco-related bonds.

There is the question of how the proceeds will be used in the State's fiscal plan. A securitization plan gives a state the opportunity to articulate public policy objectives with respect to the use of a major revenue source - tobacco settlement proceeds. Generally, securitized tobacco settlement proceeds can be used to finance pay-as-you-go capital expenditures, refund current State debt, address a budgetary shortfall, and/or fund an endowment for designated program needs (i.e. infrastructure, healthcare, education).

The Governor's tobacco securitization plan is essentially designed to finance a budget deficit in fiscal year 2003, and reduce the size of anticipated future budget shortfalls. The proposed tobacco securitization plan does not provide a solution to the State's long-term structural budget gap. Rather, it simply attempts to "buy time" until the economy rebounds and tax revenue growth accelerates faster than expenditure growth.

The Administration argues that in addition to transferring risks from the State's general fund to bond holders, securitization of tobacco settlement revenue restructures the State's revenue stream to permit near-term investments in areas that will yield long-term benefits.

RIPEC can appreciate the need to find solutions to the projected FY 2003 budget deficit, and the use of tobacco proceeds through securitization certainly offers an option to the State. Indeed, if the proceeds of securitized tobacco revenue were not used to balance the FY 2003 budget, the Governor and General Assembly would have to consider budget cuts, tax increases, or a combination of both. However, given the volume of resources from the tobacco securitization, RIPEC believes there is an opportunity to use a portion of the proceeds to create a permanent endowment to address and support investments to improve the State's overall competitiveness and to create jobs. This option, however, may not be feasible as long as the State's fiscal policy is premised on the concept that spending future revenue is an alternative to reducing current costs.

It appears that some form of securitization may be inevitable; therefore, to protect taxpayers, any securitization plan should consider the following:

- Create a special, single-purpose entity (SPE) to sell the future tobacco settlement revenues through bonds. The SPE should be authorized to finance both capital and working capital expenditures. In addition, it is important to ensure that the SPE be bankruptcy remote.
- Issue tax exempt bonds for capital or deficit reduction to lower borrowing costs while the use of some taxable bonds should be considered for the establishment of an endowment; and
- Gauge the percent of the tobacco settlement pledged to meet the dollar target for use of the proceeds.
- Consider a full turbo amortization schedule to eliminate the debt as soon as possible and lower borrowing costs.

Personnel: As noted earlier in this report, FY 2003 personnel expenditures are expected to increase by \$67.0 million – a net increase of 5.4 percent. This includes funding for a 4.5 percent COLA for most State employees. The average cost per FTE position of \$66,654 will represent a 6.7 percent increase from FY 2002. While the Governor’s FY 2003 budget holds the line on the number of authorized FTE positions (15,862.0 FTE positions) there are several issues that need additional attention.

First, given that the State continues to operate with 500.0 or more vacant FTE positions during most of the fiscal year, the State should develop a target for filled FTE positions and manage to meet that goal. This may require eliminating lower priority positions and restricting non-essential positions. The current cap on authorized FTE positions should be lowered to reflect these targets. The most effective method of deriving permanent savings through attrition, program reductions or program elimination is ensuring that the related staffing is eliminated.

Second, in FY 2001, the State provided language to exempt 330.4 FTE positions in higher education on the premise that these positions were funded by third-party resources - such as University funds and Federal Funding. The number of exempt positions has since increased to 442.7 FTE positions – a 112.3 FTE position increase (34.0 percent increase). The exempted positions were identified in order to provide the State’s University additional flexibility in managing staffing patterns.

While this may be desirable for the University, it represents erosion of a tool that the State has to control spending. The requirement to get authorization for FTE positions permits the State to evaluate all positions that may impact the overall fiscal health of the State. This fiscal tool applies needed pressure on spending patterns to ensure that departments, agencies and programs fully understand the fiscal implications of additional staffing. In addition, the FTE position authorization process is a means for the State to effectively measure the effectiveness of any initiatives to reduce or consolidate programs and departments. Without effective control over staffing, it is very difficult to manage permanent savings into proposed changes in government structure.

The State implemented the legislative authorization of FTE positions in order to begin understanding total personnel costs, staffing patterns and the proliferation of programs. An issue that the State continues to face is the impact third party financing has on the management of the entire budget. While positions and programs may initially receive other sources of funding, these positions and programs may shift over to the State’s general revenue fund once other funds have expired.

Therefore, given the limited number of effective cost containment tools available to the State, RIPEC continues to voice its concern about procedures and policies that exempt certain FTE positions in the State’s budget.

A related issue is the Governor’s budget proposal to create a new class of positions called *limited service positions*. These positions would not be subject to the FTE position authorization spelled out in the annual appropriations bill. According to Article 38 of the Governor’s proposed budget, these positions would be funded by non-general revenue sources of revenue and would

be limited to one year of employment. These positions would not be eligible for retirement, health or other benefits ordinarily provided to state employees. The budget article clearly states that the limited service positions are being created in order to avoid the restrictions under the current FTE position authorization process.

Again, RIPEC questions the creation of mechanisms to circumvent the FTE position authorization process. Permitting the creation of such a class of positions would undermine the current process, limit policymakers' ability to manage personnel costs, and could represent a portion of the budget that could be subject to abuse. In addition, RIPEC raises the concern that the State often finds itself in a position to fund programs created under third-party funding that is in need of State support due to the termination of third party funding.

The State's budgeting practices for overtime and purchased service expenditures also require additional attention. Overtime expenditures in both FY 2001 and FY 2002 exceeded the amount enacted by the General Assembly. As noted earlier in this report, actual FY 2001 experience in overtime expenditures exceeded the enacted appropriations by 50.0 percent. Similarly, the experience in purchased services (private contracts) has demonstrated consistent under-budgeting expenditures in both FY 2001 and 2002. While the FY 2003 shows reduced overtime and purchase service costs, policy-makers should ensure that enacted appropriations are realistic and not lower than anticipated expenditures.

State Aid and Property Taxes: Table 14 displays the major state aid programs the State provides to local communities. The Governor's FY 2003 Budget includes a net increase of \$39.1 million in local aid – a 5.1 percent increase from FY 2002 revised local aid. However, RIPEC estimates that the Governor's FY 2003 proposed budget actually represents a reduction of approximately \$62.0 million in direct State aid to municipalities based on current law.

State Aid Category	Revised 2002	Proposed 2003	Proposed Change
Direct Education Aid	\$600.2	\$617.6	\$17.4
Excise Tax Phase Out	76.7	86.5	9.9
General Revenue Sharing - Inventory Tax	43.6	48.3	4.7
PILOT	18.1	18.2	0.0
Distressed Communities	7.5	7.6	0.1
Public Service Corporations Tax	16.7	23.4	6.7
Library Aid	8.3	8.6	0.3
Total	\$771.2	\$810.2	\$39.1

Source: RIPEC calculations based on FY 2003 Budget documents

Phase Out of the Excise Tax on Motor Vehicles: The State embarked on an eight-year program to phase-out the excise tax on motor vehicles by FY 2007. The program requires all communities to freeze motor vehicle excise tax rates at the FY 1998 level, and increases the amount of vehicle value exempt from taxation until all vehicle value is exempt in FY 2007. In making up the lost revenues generated by the tax, the State holds communities harmless through advance reimbursements adjusted for inflation.

As noted earlier, the Governor has proposed as part of the FY 2002 revised budget to permanently freeze the eight-year phase out of the local excise tax on motor vehicles. The FY 2002 and FY 2003 figures on Table 14 represent the Governor's funding relative to that proposal. The Governor has included additional funding to accommodate the inflation adjustment on the local tax rates on motor vehicles that were frozen at the FY 1998 levels. However, the Governor's proposal would permanently stop the program at FY 2001 level (\$3,500 exemption).

If the Governor had fully funded the program in FY 2002 (\$5,000 exemption), the budget would require approximately \$106.7 million – nearly \$30.0 million more than the Governor has proposed. In addition, it is estimated that the FY 2003 appropriation required to fully fund the program (\$6,900 exemption) would be approximately \$140.6 million, requiring \$54.1 million more than the Governor has proposed.

General Revenue Sharing: The program is based on the percentage of total state tax collections from two years prior. In FY 1999, the State started to eliminate retail, wholesale and auto dealers' inventory taxes over a ten-year period, freezing FY 1999 rates and requiring localities to reduce rates annually by 10 percent. Concurrently, the State embarked on a ten-year program to increase the percentage in the General Revenue Sharing Program from 1.3 percent in FY 1999 to 4.7 percent by FY 2009 to reimburse municipalities for revenues foregone.

The Governor's FY 2003 plan recommends pushing back the scheduled increase in the General Revenue Sharing percentage one year, thereby keeping it at 2.4 percent of State revenues in FY 2003 rather than increasing it to 2.7 percent as is required by current law. Current law would require approximately \$54.3 million, nearly \$6.1 million more than the \$48.3 million included in the Governor's FY 2003 Budget request. What should be noted is that while the Administration has proposed shifting the State's programmed increase General Revenue Sharing, there are no provisions that would permit the local communities to delay the next reduction in the inventory tax for one year.

Table 15
General Revenue Sharing and the Phase Out of Inventory Tax

Fiscal Year	Current Law	Governor Proposed
1998	1.0%	1.0%
1999	1.3%	1.3%
2000	1.7%	1.7%
2001	2.0%	2.0%
2002	2.4%	2.4%
2003	2.7%	2.4%
2004	3.0%	2.7%
2005	3.4%	3.0%
2006	3.7%	3.4%
2007	4.1%	3.7%
2008	4.4%	4.1%
2009	4.7%	4.4%
2010	4.7%	4.7%

Source: 45-13-1 of RIGL and Article 7 of Governor's FY 2003 Budget Request.

Payment-in-Lieu-of-Taxes (PILOT): Established in 1986, the PILOT program is designed to provide payments to local communities for various institutions that are not on local property tax rolls. The program provides a rate of reimbursement of 27.0 percent of taxes that would have been collected if the properties were taxable.

The Governor has proposed to level fund the PILOT program at \$18.2 million, which would represent a reduction in the rate of reimbursement from 27.0 percent to approximately 25.0 percent. The Proposed FY 2003 Budget would have required an appropriation of \$19.8 million,

nearly \$1.6 million more than proposed by the Governor. The Governor's FY 2003 budget also proposes language to enable the Governor to ratably reduce the appropriation for the PILOT program rather than to appropriate to the statutorily established rate of 27.0 percent.

Public Service Corporations Tax: By statute, local communities are not permitted to levy tangible property taxes on specific assets of cable, telegraph and telecommunications corporations. Rather, the State levies and collects taxes on these assets based on the statewide average tax rate and the average assessment ratio in the State. Then it distributes these collections back to the cities and towns based on a formula based on a community's population relative to the State's total population.

The Governor's FY 2003 Budget includes \$23.4 million in anticipated collections from this program, which is \$6.7 million more than FY 2002. The Governor has proposed to modify the methodology used to calculate the taxes collected in the State. The FY 2003 proposal is to use a weighted average tax rate, generating the additional \$6.7 million in net revenues, which would then be distributed to the cities and towns. There is no indication what the potential impact would be on the necessary investments in the telecommunications industry if this proposal were enacted.

Education Aid: As shown on Table 16 on the following page, the Governor's FY 2003 direct education aid program would total \$617.6 million to local school districts – a \$17.4 million increase from FY 2002. The Governor's proposal targets 89.0 percent of the net increase to the urban communities while guaranteeing a minimum increase for all districts of 1.0 percent.

The change in the Governor's state aid programs may have unintended negative consequences on the State's economic competitiveness. For example, modifying the General Revenue Sharing Program was a quick pro quo for phasing out the inventory tax. As a result of the Governor's proposal, the phase out of the inventory tax could be delayed, or higher property tax rates could result. Modifying the PILOT program could effect cities and towns who provide municipal services to tax-exempt agencies that are major economic engines in urban Rhode Island. Halting the phase out of the motor vehicle excise tax will not only effect homeowners but will effect the property tax bills of small businesses throughout the State. Finally, changing the method of levying the public service corporations tax could have an adverse impact on investment in telecommunications infrastructure needed to compete in the new economy.

Table 16
FY 2002 & FY 2003 State Education Aid By District

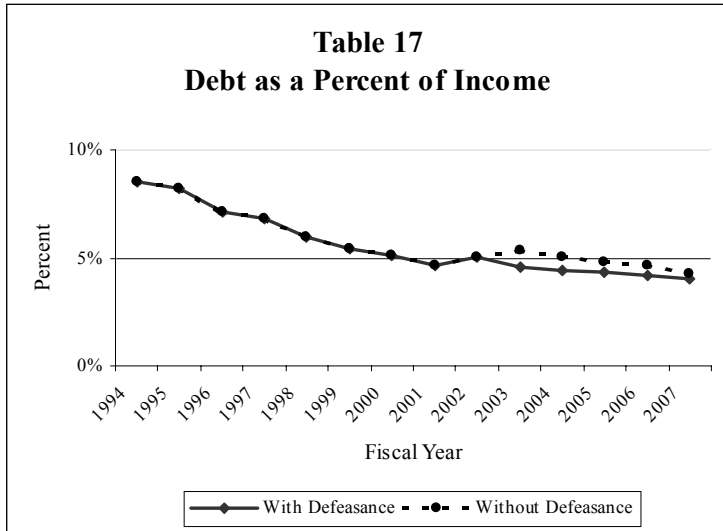
District	2002 Total	2003 Total	(2002-03) Change	(2002-03) % Change
<u>Urban Core</u>				
Central Falls (1)	\$33,639,124	\$34,440,627	\$801,503	2.4%
Newport	10,065,853	10,229,442	163,589	1.6%
Pawtucket	56,785,845	60,024,535	3,238,690	5.7%
Providence (1)	169,002,893	176,662,178	7,659,285	4.5%
Woonsocket	41,551,538	43,059,505	1,507,967	3.6%
<i>Subtotal</i>	<i>\$311,045,253</i>	<i>\$324,416,287</i>	<i>\$13,371,034</i>	<i>4.3%</i>
<u>Urban Ring</u>				
Cranston	\$31,098,284	\$31,409,267	\$310,983	1.0%
East Providence	23,830,537	24,145,725	315,188	1.3%
North Providence	11,937,013	12,056,383	119,370	1.0%
Warwick	33,502,797	33,837,825	335,028	1.0%
West Warwick	17,658,912	18,643,537	984,625	5.6%
<i>Subtotal</i>	<i>\$118,027,543</i>	<i>\$120,092,737</i>	<i>\$2,065,194</i>	<i>1.7%</i>
<u>Suburban</u>				
Barrington	\$2,294,840	\$2,336,081	\$41,241	1.8%
Bristol-Warren	18,393,960	18,577,900	183,940	1.0%
Cumberland	11,816,925	11,973,705	156,780	1.3%
East Greenwich	1,642,030	1,658,450	16,420	1.0%
Jamestown	453,231	459,436	6,205	1.4%
Johnston	9,607,836	9,703,914	96,078	1.0%
Lincoln	6,669,256	6,735,949	66,693	1.0%
Middleton	9,194,316	9,286,260	91,944	1.0%
Narragansett	1,616,920	1,633,089	16,169	1.0%
North Kingston	10,851,375	10,959,888	108,513	1.0%
Portsmouth	5,535,991	5,591,351	55,360	1.0%
Smithfield	4,925,915	5,054,613	128,698	2.6%
Westerly	5,994,381	6,146,521	152,140	2.5%
<i>Subtotal</i>	<i>\$88,996,976</i>	<i>\$90,117,157</i>	<i>\$1,120,181</i>	<i>1.3%</i>
<u>Rural/Emerging Suburban</u>				
Burrillville	\$12,458,207	\$12,582,788	\$124,581	1.0%
Chariho (2)	13,367,322	13,505,603	138,281	1.0%
Coventry	18,103,867	18,284,906	181,039	1.0%
Exeter-West Greenwich	6,602,455	6,682,778	80,323	1.2%
Foster	1,257,914	1,270,493	12,579	1.0%
Foster-Glocester	5,173,788	5,225,526	51,738	1.0%
Glocester	2,871,779	2,900,497	28,718	1.0%
Little Compton	312,417	315,541	3,124	1.0%
New Shoreham	79,523	82,891	3,368	4.2%
North Smithfield	4,258,219	4,300,802	42,583	1.0%
Scituate	3,068,641	3,099,327	30,686	1.0%
South Kingston	9,219,644	9,311,841	92,197	1.0%
Tiverton	5,324,482	5,377,727	53,245	1.0%
<i>Subtotal</i>	<i>\$82,098,258</i>	<i>\$82,940,720</i>	<i>\$842,462</i>	<i>1.0%</i>
State Total	\$600,168,030	\$617,566,901	\$17,398,871	2.9%

(1) Includes estimated share of progressive intervention funding.

(2) Chariho School District's State Aid represents Charlestown, Hopkinton and Richmond

Source: R.I. Department of Education, State budget documents, and RIPEC calculations.

Debt: Debt management practices, such as paying off DEPCO obligations, combined with personal income growth have resulted in the State's overall debt burden as measured by debt per \$1,000 of personal income decline. State efforts have resulted in reducing the net tax supported debt as a percent of personal income from 8.5 percent in FY 1994 to 5.0 percent in FY 2002. As a result of these and other debt reduction initiatives, net tax-supported debt as a percentage of personal income is projected to decline to 4.3 percent in FY 2007. If the State were to enact the Governor's proposal to use tobacco securitization proceeds to defease \$272.0 million in General Obligation debt, the State's net tax-supported debt as a percentage of personal income would decline to 4.0 percent by FY 2007.

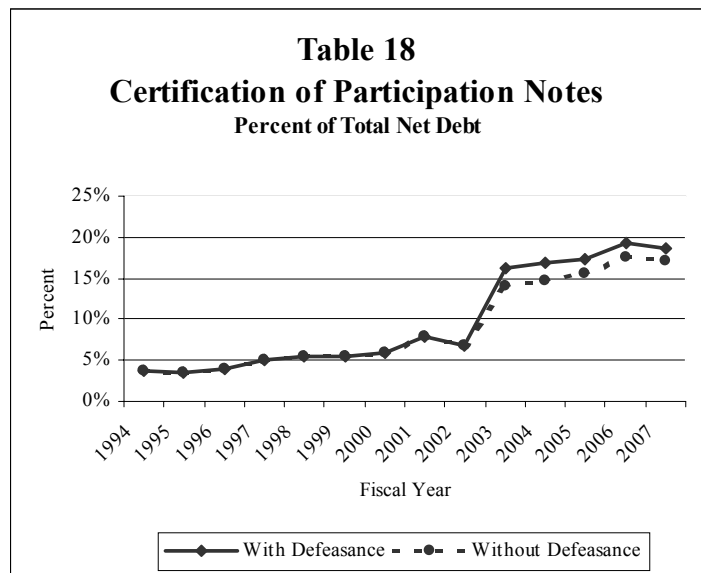


While all capital projects are fully disclosed in the State Capital Budget and are reviewed by the General Assembly, an area that requires more attention is the State's use of third party arrangements to finance capital projects. The use of Certificates of Participation Notes (COPS) is one method of entering into these arrangements without voter approval.

Certificate of Participation financing is estimated to increase from 3.7 percent (\$69.8 million) of net tax supported debt in FY 1994 to a projected 17.2 percent (\$293.0 million) of net tax supported debt in FY 2007. If the State were to enact the Governor's proposal to use tobacco securitization proceeds to defease \$272.0 million in debt, COPS financing would increase to 18.5 percent of net tax supported debt in FY 2007.

There are a number of capital projects funded through COPS financing, including approximately \$125.0 million in various projects for the Department of Corrections (i.e. maximum and high security additions, and the construction of four community corrections facilities).

Other projects funded through COPS include \$52.0 million for the Kent County Courthouse and \$58.0 million for the DCYF Training School (which has increased from an original proposal



of \$40.0 million in the previous capital plan published by the Budget Office). The Capital budget has also returned to using COPS financing for various equipment and vehicle leases.

While these projects may be worthwhile, State policy makers should explore whether the use of COPS financing is the most appropriate method to complete each project. Many of these projects are in the latter years of the Capital Plan, and therefore could lend themselves to presentation for voter approval if deemed a high priority.

Before approving new authority to issue over \$200 million in new long-term financial obligations without voter approval, State policy makers should establish clear policies regarding the use of COPS. These policies should include, but not be limited to, defining the size, scope and type of projects that should be financed by COPS rather than traditional financing arrangements that are subject to voter approval. Consideration should also be given to whether a cap on the amount of the State's total debt that can be financed through COPS is prudent.