



RIPEC

## FY 2006 State Budget Analysis

### Summary of RIPEC Comments

Since FY 1996, the average annual rate of growth in general revenue spending has been approximately 5.9 percent – compared to 4.6 percent annual growth in personal income. Inflation, as measured by the Consumer Price Index (CPI) has been running at 2.3 percent annually during this period. The Governor's FY 2006 budget request represents a 4.5 percent increase in general revenue spending over the FY 2005 enacted budget. The average cost per FTE position is projected to increase by 4.8 percent. The Governor's five-year forecast shows operating deficits averaging \$100 million through the end of the decade. The following analysis focuses on policy choices to enhance fiscal discipline.

- Given the lack of financial discipline engendered in the budget process, RIPEC is calling for a thorough analysis of options to implement a tax or spending limit on the State budget. RIPEC believes there is an immediate need to establish a two-thirds (supermajority) vote of both houses to pass a tax increase or impose new taxes.
- The Governor's FY 2006 Budget Request includes a number of initiatives that would begin to move the State in the right direction, including pension reforms, reorganization of selected central services and the inclusion of the Judiciary as part of the Executive Budget request.
- While RIPEC is supportive in principle of the Governor's Job Partnership Act, the Governor has yet to submit detailed legislation that would set forth the administration of the initiative, and RIPEC believes that consideration should be given to alternative funding options and the relative scale of the high priority initiatives in the proposal.
- RIPEC continues to call on State policymakers to establish a Tax Analysis Office. Given the complex and often fluid nature of tax policy, it is critical that the State maintain a professional team to provide policymakers with ongoing, substantive tax policy analysis.
- In RIPEC's February 2005 report – *Pension Reform in Rhode Island* – RIPEC called upon the General Assembly to adopt pension reforms that would address the increasing pension costs and improve the two pension systems' unfunded liability. Of the \$8.7 billion in projected pension liability, 35.0 percent is currently unfunded.
- Given Medicaid represents 30.0 percent of the budget and the uncertainty of Federal action, RIPEC calls for the establishment of an Office of the Secretariat for Health and Human Services and the development of a unified Medicaid Budget.
- RIPEC also raises concerns over a number of recent budgeting practices, such as certain governance issues related to the Judiciary and Higher Education, and realistically budgeting revenues and certain expenditures, such as overtime and purchased services expenditures.

April, 2005



## I. RIPEC Comments

It is essential for the economic future of the State to maintain a fair and competitive tax climate. In order to achieve this goal, Rhode Island must focus on controlling the rate of growth in spending, setting investment priorities, and effectively managing its limited resources.

Summary	FY 2004	FY 2005	FY 2006
<b>Total - Opening Surplus</b>	\$50.0	\$57.8	\$10.7
<b>Revenues</b>			
Enacted	\$2,844.9	\$2,954.4	\$0.0
Nov Estimating Conference		22.9	3,033.1
Governor Changes		(0.5)	89.3
<b>Total Revenues</b>	<b>\$2,844.9</b>	<b>\$2,976.8</b>	<b>\$3,122.4</b>
Cash Stabilization	(\$57.8)	(\$60.5)	(\$62.7)
<b>Total Available Revenues</b>	<b>\$2,837.2</b>	<b>\$2,974.1</b>	<b>\$3,070.4</b>
<b>Expenditures</b>	<b>\$2,779.4</b>	<b>\$2,963.5</b>	<b>\$3,069.5</b>
Free Surplus	\$47.7	\$10.7	\$0.9
Reappropriations	10.1	-	-
<b>Total Ending Balance</b>	<b>\$57.8</b>	<b>\$10.7</b>	<b>\$0.9</b>

Source: RIPEC Calculations based on FY 2006 Governor's Budget

The Governor's FY 2006 general revenue budget request would represent a 3.6 percent increase from the FY 2005 Revised Budget. The FY 2006 proposed budget would represent a 4.5 percent increase from the budget originally enacted for FY 2005. As presented, the budget would grow at a slower rate than personal income, which is projected to grow by 4.1 percent during the fiscal year. However, given recent experience with supplemental appropriations, under-budgeting overtime and purchased services, and the potential impact of Federal decisions regarding Medicaid, the FY 2006 budget growth may not remain under 4.0 percent.

Table 1 shows the State's Budget Statement from FY 2004 through FY 2006. The State has experienced opening surpluses

exceeding \$50 million in both FY 2004 and FY 2005. However, the Governor's FY 2006 budget relies on an opening surplus of \$10.7 million.

Since FY 1996, the average annual rate of growth in general revenue spending has been approximately 5.9 percent, while the average annual rate of growth in personal income in the Ocean State has been 4.6 percent. Inflation, as measured by the Consumer Price Index (CPI) has been running at 2.3 percent annually during this period.

Combine this experience with projected State operating deficits exceeding \$100 million annually through FY 2010, and one can see that there is a compelling need to begin reigning in the State's overall spending growth.

The following RIPEC Comments outlines a few key issues that are either raised by the proposed FY 2006 budget or are of some concern as policy makers debate the budget in the coming months.

**Tax and Expenditure Limits (TEs)** – Greater fiscal discipline should be built into the State budget process. According to the National Conference of State Legislatures, 21 states have some type of "true" tax or spending limitation. Tax and expenditure limits (TEs) are designed to curtail growth in government spending by placing constitutional or statutory restrictions on the amount a state can spend or tax its citizens.

Limits on what government can tax and spend should be viewed as a positive force in improving productivity, emphasizing efficiency, highlighting truly vital services, and freeing government from the obligation to do things whose benefits do not match their cost.

Without limitations on government spending and taxation, discipline may be overshadowed by political pressures of the moment. With limitations, taxpayers' economic well-being and government performance will both be enhanced. However, designing an effective TEL is a complex task.

A review of the literature found the effectiveness of TELs varies depending on design. Therefore, RIPEC would urge that study and analysis be devoted to determining what type of TEL would be in the State's long-term fiscal interest. As an immediate step to begin building fiscal discipline into the budget process, RIPEC would urge that the budget contain a provision requiring a two-thirds vote (supermajority) of both houses of the General Assembly to pass tax increases or impose new taxes.

**Jobs Partnership Act** - The Governor's FY 2006 Budget Request includes a number of initiatives related to economic development. One such proposal is the Jobs Partnership Act, designed to authorize the State's Economic Development Corporation (RIEDC) to issue \$54.0 million in moral obligation bonds to finance a number of economic development initiatives. (It should be noted that the FY 2006 budget bill currently does not have specific language describing the issuance or use of proposed funding):

1. *\$25.0 million – Growth Center Jump Start Program* – A revolving loan fund to create “pad-ready” sites in designated growth centers.

2. *\$15.0 million – The Slater Fund* – The funds would create a public financing commitment to the Slater Fund to leverage private venture capital to expand the capacity of the State's Slater Centers.
3. *\$10.0 million - Small & Minority Business Growth Fund* - The concept is to leverage funds with private lenders to provide access to capital.
4. *\$4.0 million – Northern Rhode Island Biotechnology Facility* – These funds would finance the development of a 100,000 sq. ft. flex space for biopharmaceutical use.

Rhode Island is limited in good industrial and office space, and there are impediments to ensuring that companies can access and occupy facilities in reasonable periods of time. Some estimates show that occupancy can take up to three years. In addition, small business entrepreneurs continue to demonstrate that they are one of the engines of the State's economy, and it is essential that these companies have access to capital to expand and enhance their businesses.

While these issues are important and require attention from policymakers, RIPEC has identified a number of questions with this proposal that should be considered prior to taking action. First, while the proposal is summarized in the Governor's FY 2006 Executive Summary, the budget bill does not have any language that would implement such an initiative. There is little information as to the mechanisms that would be put in place, how they would be administered, how they would function over time, and how these investments would be evaluated. Therefore, it is difficult to properly assess the proposal in a meaningful way until details are made available.

Second, RIPEC has concerns regarding the State's overall indebtedness. In October 2004, RIPEC reported that Rhode Island ranked 12<sup>th</sup> highest in overall debt per \$1,000 of personal income. Issuing additional debt, such as the moral obligation bonds proposed here, continues to increase the State's overall indebtedness. Should the Governor and the General Assembly deem these projects worthy of funding, consideration might be given to using the Rhode Island Capital Fund to finance some of these initiatives rather than issuing additional debt. While some might argue that moral obligation bonds are different from general obligation bonds, they nevertheless increase the State's overall net tax supported debt.

Third, the breadth of the proposal for using the \$54.0 million covers considerable ground in that there are four initiatives to be funded under this program. While one can understand that the funds should be used for a range of purposes, does the proposal provide adequate scale for all of initiatives envisioned? Part of the motivation behind the Jobs Partnership Act is to address the need to invest in land assembly and other capital needs to a certain scale. This is very important in order to compete with other potential sites for growing businesses. Therefore, consideration might be given to fewer projects and using more of the \$54.0 million to create pad-ready sites, thereby giving the State more capital to work with to develop these opportunities.

Lastly, the Governor's FY 2006 operating budget request includes \$3.0 million for the Slater Centers, consistent with prior year funding. Should the State enact the Jobs Partnership Act and establish a \$15.0 million fund for the Slater Centers, what is to become of the ongoing annual appropriation for the Slater Centers?

**Tax Policy** – The FY 2006 Budget does not include any major tax reductions or reforms. The Governor's request, however, does request "\$100,000 of initial seed money for the purpose of assessing the State's need for a tax policy analysis capability."

In RIPEC's opinion, this worthwhile initiative does not go far enough considering the need to immediately enhance the State's tax analysis and research capabilities.

As currently organized, the State's approach to tax analysis is disjointed. For example, the Division of Taxation does not have a unit devoted solely to researching, analyzing and preparing tax policy options. The EDC often proposes tax policies, but that agency is responsible for analyzing the economic impact of projects that it is promoting. The Budget Office may consider tax policy issues, but the office is primarily responsible for proposing revenue enhancements in the Governor's budget. Finally, unlike some other states, the General Assembly does not have a standing committee or sub-committee that focuses solely on taxation.

Over the next several years, policy makers in Rhode Island will have to address fundamental tax questions that will determine how fair, balanced and competitive the Ocean State tax structure will be for the next decade. This could include a review of the State personal income tax, an analysis of options to reduce the reliance on the local property tax, efforts to ensure a properly balanced system of taxation, and a study of consumption taxes in the era of the multi-state streamlined sales tax agreement.

Decision-makers must not only consider the fiscal impact that tax programs may have on revenues, but they must also understand the behavioral consequences that may result

from tax policy changes. In addition, policymakers must understand the potential impact on the State's economy and private investments, the distributional burden associated with any tax change, as well as the tax policy's potential benefits.

Therefore, reviewing, analyzing, monitoring and proposing tax policy must be supported by a professional staff and appropriate resources in both the executive and legislative branches of State government.

RIPEC recommends establishing a Tax Analysis Office. This unit would be assigned responsibilities such as collecting data to measure tax incidence, taxpayer liability by economic activity, measuring whether tax incentives are achieving their desired results, and identifying tax policy issues and developing options. The Office could serve as an information clearinghouse on tax issues, and be responsible for maintaining a state-of-the-art econometric tax modeling capacity.

The Office should develop and maintain expertise in data collection and statistical analysis to provide qualitative and quantitative analysis of the state and local tax structure and various tax incentives; provide fiscal and tax incidence analysis for tax and tax-related proposals recommended or under consideration by the Governor and the General Assembly; provide an ongoing study of the state and local tax structure, identifying trends that should be considered in tax policy development; monitor the impact Federal tax policies and actions may have on the state and local tax structure and revenue product; analyze the impact tax changes may have on state and local economic conditions; and conduct studies that provide the Governor, the General Assembly and local officials with analysis with respect to proposed changes to tax law.

**Pension Liability** – In February 2005, RIPEC published a report analyzing the Governor's pension reform proposal and making suggestions on how to improve the overall financial condition of both the State employee and teacher pensions systems.

Integrated into the Governor's FY 2006 budget is the pension reform initiative. The Governor has proposed to establish a minimum age to retire at age 60 with 30 years of service (65 with 10 years), change the accrual formula for calculating benefits (the maximum benefit decreasing from 80 to 75 percent of AFC), and benchmark the COLA based on the CPI capped at 3.0 percent. These changes would apply to new hires and non-vested employees. The Governor has also proposed that any State surplus exceeding \$30.0 million would be used to reduce unfunded liabilities.

The proposal would translate into a projected cumulative savings for state and local government in both pension systems of \$1.3 billion, representing an average annual savings of approximately \$70.9 million over the 18-year period (FY 2005 – FY 2023).

The increasing costs of the two pension systems are major drivers of the growth in State spending. The immediate fiscal impact of the growth in the State and local contribution to these funds will make it increasingly difficult to control costs and target resources to other priorities.

For example, in FY 2006, the State will need to increase its contributions for State employees by \$38.3 million (from \$72.4 million to \$110.7 million). State and local governments will need to increase the contribution for teacher pensions by \$51.2 million – from \$128.5 million to \$179.7 million.

In addition, the overall funding status of the funds should be of concern. Combined, the two pension systems have nearly \$3.1 billion in unfunded liability (as of July 1, 2003). This represents nearly one-third of the total liability for the two pension systems.

These budget demands create a considerable restraint on the State and its local communities' abilities to direct resources to other pressing matters. Therefore, it is imperative that the General Assembly adopt pension reform legislation this session.

As Legislative leaders consider changes to the pension system, RIPEC does raise concerns regarding two aspects of the Administration's proposal:

1. Allocating State surplus funds in excess of \$30.0 million to reduce unfunded liabilities in the pension funds; and
2. Redirecting all contribution savings derived from the changes in employee benefits to the State's operating budget rather than using a portion of the savings to shore up the pension systems, thereby improving their overall funding status.

The Administration has proposed allocating State surplus funds in excess of \$30.0 million to reduce the unfunded liabilities in the State Employee Fund, the Teacher Fund, and the State's unfunded health care liability. While the use of surpluses in excess of \$30.0 million warrants consideration, there are a number of practical questions as to how it would be administered, as well as fundamental fiscal policy issues to consider. For example, the timing of establishing the surplus, how it interacts with revenue forecasting, and what

impacts it may have on the Governor's annual operating budget development are all questions that would need clarification.

RIPEC recommended in its February pension analysis that consideration be given to a five-year program to move the savings resulting from the pension benefit changes away from the operating budget and into the retirement funds to increase assets and to reduce the projected unfunded liability. The end result is that approximately 92.0 percent of the anticipated savings to the State from the changes in the pension would remain in the pension funds rather than directed to the State's operating budget.

**Medicaid** – Growth in Medicaid will, by itself, continue to create a large structural problem in the State's budget. Medicaid expenditures in the FY 2006 budget will represent 30.0 percent of all State spending. Medicaid expenditures have increased by nearly 70.0 percent since FY 2000. In addition to continued growth in Medicaid spending, there is growing concern over what impact Federal action may have on the State's financial condition.

President George W. Bush proposed reductions in Medicaid reimbursements to states in his FY 2006 budget, amounting to \$45.0 billion in Federal savings over the next 10 years. Depending on how they are structured, cuts in Federal funding could impact Rhode Island.

While some of the proposals would affect the overall size of the Medicaid program - reducing costs both for the Federal government and the states – several proposed changes could reduce Federal reimbursement to states. This is of concern for states (including Rhode Island) that have expanded programs beyond minimum requirements of Medicaid.

The President's proposals include reducing both the types of services for which reimbursement may be claimed under the targeted case management structure, and the matching rate from the state's current Medicaid matching rate to 50.0 percent. In addition, the President's budget includes a proposal to convert Medicaid to a block grant after FY 2006.

The Medicare Prescription Drug, Improvement, and Modernization Act of 2003 may also impact the State's finances in the coming decade. Under the law's provision, the Federal government will provide prescription drug coverage to those individuals who are eligible for both Medicaid and Medicare, a responsibility that currently rests with the states.

The new law included a provision that has Medicare pay for the drug costs for those who are dually eligible. In exchange for these savings to the states, the new law also included a provision – the “claw back” provision – requiring states to reimburse the Federal government for a portion of the estimated savings from Federal drug coverage for those who are dually eligible. The “claw back” is set at 90.0 percent of estimated state savings in the first year of the drug benefit (FY 2006), declining to 75.0 percent of estimated state savings over 10 years.

The impact of this new law on the State budget is not clear at this point. The State's FY 2006 budget does not include any payments or savings relating to the law. In addition, the five-year forecast developed by the Administration does not incorporate any potential impacts this may have on the State's overall financial condition.

These and other potential changes to the Medicaid and Medicare Programs are complicated and substantial to the State. Therefore, RIPEC continues to call for the establishment of the Secretariat of Health and Human Services. The proposal offers an opportunity for greater accountability and policy coordination among the agencies whose budgets represent nearly 40.0 percent of the entire State budget, and handle all aspects of the State's Medicaid and Medicare programs.

The Office of the Secretariat would be in a position to address program issues that cut across department responsibilities, coordinate the fiscal and policy framework driving the departments and ensure that clients have access to efficient and effective services.

While coordinating policy and programs will be essential, the first task that will require considerable effort is the development and maintenance of a unified Medicaid Budget. A unified Medicaid budget could lead to greater accountability of department operations (*RIPEC will publish a Medicaid analysis April 19, 2005*).

**Integrity of the Budget** - The development of the State's annual operating budget is central to the policy structure the State will operate within over the course of the current and coming fiscal years. Therefore, it is essential that the State develop and maintain effective budgetary practices, thereby ensuring the long term integrity of the policy-making process. There have been actions in recent years that begin to raise questions about the budget process and budgeting authority. The following highlights some of the issues RIPEC believes warrant additional attention in the coming budget debates.

*Judiciary Budget* – Article 45 of the FY 2005 Budget as Enacted included language that provides the Judicial branch with additional controls over its budget, purchasing and personnel procedures. The Judiciary’s budget is not subject to amendment by the Governor, and the Judiciary is now permitted to set up its own rules, regulations and procedures relating to purchasing, payroll, merit system and auditing practices.

While there is a need to ensure an independent Judiciary, RIPEC does not agree with the new budgetary and administrative authority bestowed upon the Judiciary in the FY 2005 Budget. Article IX, Section 15 of the Rhode Island State Constitution clearly says that it is the responsibility of the Governor to prepare a consolidated budget for the State. The Constitution states, “The governor shall prepare and present to the general assembly an annual consolidated operating and capital improvement state budget.”

RIPEC believes the Governor has a duty to review the Judiciary’s budget request and to integrate it into his or her budget request to the Legislature. There are a number of opportunities for the Judiciary to make its case for initiatives and changes to its budget. As is often the case, the Legislature has made a number of changes to appropriations to the Judicial Branch. The budgetary authority given to the Judiciary is inconsistent with the concept of a unified Executive Budget request, and such practices could create duplicative and potentially costly administrative functions that are otherwise provided by the Department of Administration.

*Higher Education* – Up until FY 2005, the Board of Higher Education had the statutory authority to reallocate appropriations in the enacted budget among and within the three institutions of higher education. The FY 2005 Budget as Enacted changed this practice, establishing separate appropriation line items for each institution and the Board of Higher Education. It should be noted that while these changes were made, the Board of Higher Education retained its authority to review and submit the higher education budget, and within each institution, there remains the ability to redirect or reallocate additional funding. The Governor has proposed to return to the previous method of budgeting and restoring the Board of Governor’s authority to reallocate state funds

There has been extensive debate regarding this action, with proponents noting that this will ensure that the Legislative intent of appropriations will be carried out while preserving the financial management flexibility at each institution. Opponents have claimed that such a change in authority circumvents the Commissioner of Higher Education and the Board of Governors, and creates an environment of Legislative micro-management.

RIPEC believes that the Legislative initiative to eliminate the Board of Governor’s ability to reallocate state appropriated funding among the higher education institutions might provide taxpayers with a clearer understanding of each of the higher education institution’s budget. The difficulty is establishing a balance between Legislative oversight and appropriate independence of the Board of Governors to oversee and set policy for the higher education institutions.

Realistic Budgeting – A recent trend has been the under-budgeting of certain components of the State’s operating budget. As the following budget analysis notes, the State has consistently under-budgeted both overtime and purchased services expenditures. RIPEC analysis shows that actual overtime experience has consistently exceeded requested and enacted appropriations by 30.0 percent since FY 2001. This is in the area of \$15.0 million in under-budgeting annually.

RIPEC has also found that supplemental appropriation requests for purchased services (contracting) follow a similar trend. For example, the State enacted a purchased services budget for FY 2005 of \$177.4 million. However, the Governor’s FY 2005 revised request includes \$198.2 million for these services – a \$20.8 million net increase (11.7 percent increase) over the enacted level. Further, the FY 2006 budget request totals \$180.3 million, a \$17.9 million decrease from the revised request (9.0 percent decrease).

Department of Children, Youth and Families (DCYF) Psychiatric Hospitals – The FY 2005 Budget as Enacted included \$7.3 million in savings for programs that were designed to reduce costs through limiting hospital stays to no more than 30 days, through transitioning hospitalized children to managed care and creating a number of “step-down” beds. Limited progress has been made in implementing the changes to achieve the savings built into the FY 2005 budget.

Therefore, the Governor’s FY 2005 Revised Budget request includes an additional \$11.4 million (\$5.3 million in general revenues) to adjust for the unrealized savings and for increased managed care premiums. The FY 2006 budget request does assume that there

will be an expansion of step-down beds to continue efforts to control costs. The general revenue supplemental request for FY 2005 represents nearly 21.0 percent of the net total general revenue supplemental request (\$25.7 million) for FY 2005.

Judicial Receivables – The Governor’s FY 2006 revenue program includes budgeting \$7.7 million in judicial fees, fines and charges to help balance the budget. According to Article 29 of the Budget bill, the Judiciary would remit to the State Controller data, including social security numbers of persons who have outstanding court costs, assessments or other obligations in order to facilitate collections of such debts. The budget article also empowers a judge or magistrate the authority to suspend the registration of a vehicle of someone who willfully fails to pay fines.

RIPEC is concerned about how successful the effort will be to collect \$7.7 million given the fact that these receivables go back to 1976.

Rhode Island Public Transit Authority (RIPTA) - An area of continued concern is the financial condition of the State’s Public Transit Authority (RIPTA). The Governor’s FY 2006 budget included an \$82.6 million operating budget for RIPTA, which represented a \$4.1 million operating deficit given projected revenues. More recent information provided by RIPTA suggests that the FY 2006 operating budget will have a \$5.2 million operating deficit given projected sales of RIte Care RIPTA passes are now projected to fall short of original projections by \$1.2 million.

RIPEC is disappointed that the FY 2006 budget as submitted had already included an operating deficit that would need immediate attention. Therefore, in the near term, it is

necessary to develop a solution to the operating deficit that considers not only revenue enhancements but more importantly, expenditure reductions and program changes.

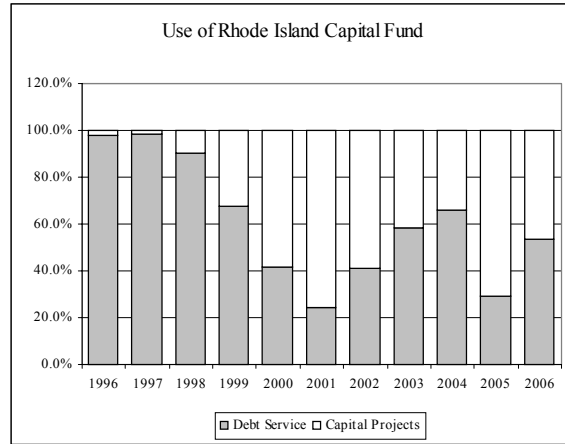
It is essential to develop a political consensus as to the role and desired levels of transit service. Is RIPTA’s focus to be one of providing services to the needy population or to build a system that provides efficient mass transportation options in Rhode Island generally? Therefore, RIPEC supports efforts to identify policy options and evaluate their costs and benefits as part of a long term get-well strategy for the State. Recent legislation has called for a Transit Commission to Study Transit in Rhode Island. There is a pressing need to complete this work quickly and to begin implementing sustainable improvements to RIPTA’s overall financial condition.

Capital Fund – Current law provides up to two percent of annual revenues to be used for capital expenditures or debt service once the Budget Stabilization Fund has reached three percent of resources. Because the Budget Stabilization Fund has reached 3.0 percent, there are only marginal contributions to the fund and most flow into the Rhode Island Capital Plan.

The Budget Stabilization Fund has increased from \$35.1 million in FY 1996 to \$62.7 million in FY 2006 – increasing by 78.6 percent over this period of time. The Rhode Island Capital Fund – the spillover fund that may be used for debt service or capital projects - has increased from \$30.0 million in FY 1996 to \$73.6 million in FY 2006 – an increase of 145.0 percent. From FY 1996 to FY 2006, a total of \$502.8 million has been spent from the Capital Fund, of which \$284.0 million (56.5 percent) was used to

support debt service and \$218.8 million (43.5 percent) for capital projects.

In the FY 2006 budget request, approximately 54.0 percent (\$39.4 million) of the \$73.6 million in the Capital Fund is proposed to be used for debt service, and the 46.0 percent (\$34.2 million) balance for capital and asset protection activities.

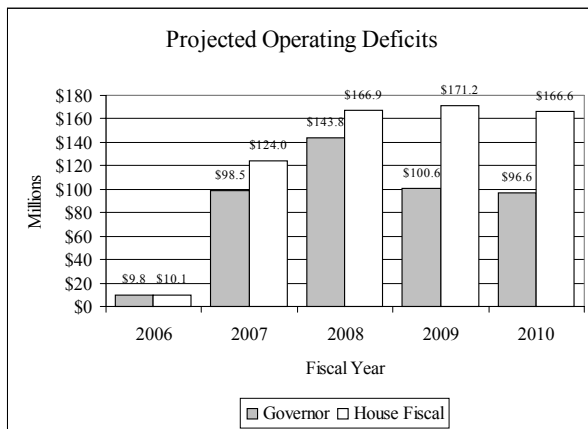


While the Capital Fund has served the State well as a countercyclical tool, there is a need to return to the State’s policy of using a greater portion of the fund for capital projects rather than debt service. This enables the State to target these funds to asset protection activities using a pay-as-you-go financing tool rather than considering long-term debt or foregoing the asset protection activities altogether.

Another issue is that the Governor’s FY 2006 budget indicates that the policy will be to return the fund to 100 percent funding for asset protection and capital projects in FY 2007. That means that the State will have to shift the \$39.4 million in debt service that would be supported by the Capital Fund in FY 2006 to the general fund in FY 2007. Given financial projections, this will be difficult to accomplish in one fiscal year.

## II. State Spending Patterns

The Governor's Budget request includes a five-year forecast projecting operating deficits of \$97.7 - \$143.8 million during the FY 2007 – FY 2010 forecast period (averaging slightly more than \$100 million). The forecast assumes general revenues in support of state spending will annually increase by approximately 5.0 percent during the forecast period while expenditures are projected to grow by approximately 5.6 percent. The expenditure growth rate is nearly three times the estimated average annual rate of inflation (2.0 percent) during this period and personal income growth is projected to grow at an average annual rate of 4.2 percent.



Growth in grants and benefits to individuals continues to apply the greatest pressure on the expenditure side of the ledger, with an average annual growth rate of approximately 6.5 percent. This is principally driven by growth in medical care.

The House Fiscal Advisory Staff has published a five-year forecast as well, forecasting operating deficits of \$124.0 million in FY 2007 to \$166.6 million in FY 2010, peaking at \$171.2 million in FY 2009. The differences in the forecasts include adjustments for certain state debt service,

and employee compensation not included in the Administration's forecast. The House Fiscal Staff also had less robust revenue growth in its forecast.

As shown on Table 2, the FY 2006 budget (all funds) represents a \$1.8 billion increase from FY 1996 (adjusted to 2006 dollars) - a 40.6 percent increase over this period (unadjusted for inflation, growth would be 76.2 percent).

Assuming the Governor's budget were adopted, expenditures supporting grants and benefits (programs providing direct support to individuals) would increase by \$899.0 million over FY 1996 adjusted expenditures, representing a 46.0 percent increase (real growth). In addition, the growth in grants and benefit spending since FY 1996 would represent half (49.8 percent) of the net total growth in State spending during this ten-year period.

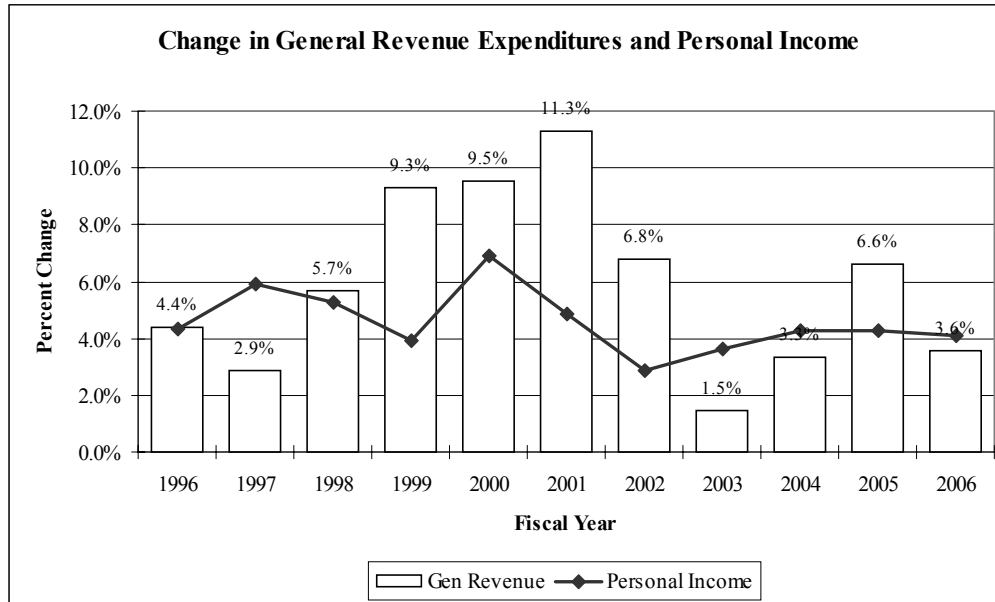
These programs include Medicaid, childcare, TANF and unemployment insurance as well as other income support programs administered by the State. The increase in managed care programs (RItE Care) of \$329.0 million represented 18.2 percent of the net increase of \$1.8 billion in statewide spending during this period.

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. Recent experience with Medicaid has shown double-digit increases.

**Table 2**  
**Rhode Island State Budget Drivers - All Funds**  
**(Adjusted for Inflation)**

<b>Expenditure Category</b>	<b>FY 1996 Adjusted</b>	<b>% of Total</b>	<b>FY 2006 Proposed</b>	<b>% of Total</b>	<b>Increase</b>	<b>Share of Increase</b>
<u>General Operations</u>						
Personnel	\$1,177.2	26.5%	\$1,496.8	23.9%	\$319.6	17.7%
Operations	339.1	7.6%	390.9	6.2%	51.8	2.9%
Subtotal - Operations	\$1,516.2	34.1%	\$1,887.7	30.2%	\$371.5	20.6%
<u>Grants &amp; Benefits</u>						
Income Support (TDI & Employ)	\$352.7	7.9%	\$374.5	6.0%	\$21.8	1.2%
Medical Assistance - Mgd Care	111.3	2.5%	440.3	7.0%	329.0	18.2%
Medical Assistance - All Other	594.9	13.4%	869.0	13.9%	274.1	15.2%
Development Disabilities	124.2	2.8%	191.3	3.1%	67.1	3.7%
Child Welfare	73.8	1.7%	116.3	1.9%	42.5	2.4%
TANF	161.3	3.6%	67.3	1.1%	(94.0)	-5.2%
Child Care	20.2	0.5%	78.9	1.3%	58.7	3.3%
SSI	24.7	0.6%	28.5	0.5%	3.9	0.2%
RIPAE	8.5	0.2%	12.4	0.2%	3.8	0.2%
Higher Education	96.2	2.2%	122.9	2.0%	26.7	1.5%
Dept. of Transportation	35.4	0.8%	51.0	0.8%	15.6	0.9%
Other Grants & Benefits	353.2	7.9%	503.0	8.0%	149.8	8.3%
Subtotal - Grants & Benefits	\$1,956.2	44.0%	\$2,855.2	45.6%	\$899.0	49.8%
<u>Local Aid</u>						
Education Aid	\$565.6	12.7%	\$763.0	12.2%	\$197.4	10.9%
Motor Vehicle Phase-out	0.0	0.0%	105.0	1.7%	105.0	5.8%
General Revenue Sharing	16.0	0.4%	53.4	0.9%	37.4	2.1%
PILOT	15.3	0.3%	22.7	0.4%	7.4	0.4%
Federal Aid	43.0	1.0%	143.7	2.3%	100.7	5.6%
Other	22.7	0.5%	57.2	0.9%	34.5	1.9%
Subtotal - Local Aid	\$662.6	14.9%	\$1,145.0	18.3%	\$482.4	26.7%
<u>Capital Expenditures</u>						
Capital Expenditures	\$95.3	2.1%	\$146.6	2.3%	\$51.4	2.8%
Debt Service	219.8	4.9%	220.2	3.5%	0.5	0.0%
Subtotal - Capital	\$315.0	7.1%	\$366.9	5.9%	\$51.8	2.9%
<b>Total</b>	<b>\$4,450.1</b>	<b>100.0%</b>	<b>\$6,254.8</b>	<b>100.0%</b>	<b>\$1,804.7</b>	

Source: RIPEC calculations based on State Budget Data - State Budget Office, DOA



In addition, policymakers constantly adjust, refine and expand programs based on policy shifts. For example, in recent years, the State has expanded eligibility for state funded health care (RItE Care), pharmaceutical assistance and child-care. In RItE Care, enrollment has increased from 71,100 in FY 1996 to a projected 133,750 in FY 2006, primarily through expansions in eligibility, as well as moving people from fee-for-service to managed care programs. The RItE Care enrollment represents 13.2 percent of the State’s estimated 2000 population.

The second largest component of State budget growth has been in local aid. All local aid increased by \$482.4 million – a 72.8 percent increase since FY 1996. The growth in local aid represents approximately 26.7 percent of the total net growth in the State budget since FY 1996. Education aid has been the principal driver within local aid. Of the \$482.4 million net increase in local aid, nearly 40.9 percent is attributable to growth in education aid.

The third largest factor in budget growth during this period has been overhead. Of the \$1.8 billion increase in net expenditure

growth from FY 1996 to FY 2006, approximately 17.7 percent (\$319.6 million) would be attributable to personnel expenditures (includes benefits). An additional 2.9 percent of the growth was related to various operating expenditures. Therefore, 20.6 percent of the net growth in the State’s total expenditure program since FY 1996 would be related to general overhead for State programs.

If one looks at overall general revenue growth only, additional information can be derived. The graph above displays unadjusted percent changes in general revenue expenditures from FY 1996 – FY 2006. It also sets forth the estimated change in personal income in Rhode Island.

Overall, the State’s general revenue budget has grown at a faster rate than both inflation and personal income since FY 1996. This trend was principally driven by increases in general revenue spending from FY 1998 through FY 2002. From FY 1996 through FY 2006, the average annual rate of growth in general revenue spending has been approximately 5.9 percent (4.1 percent adjusted for inflation). The average annual rate of growth in personal income in the

**Table 3**  
**Rhode Island State Expenditures - All Funds**

<b>By Category</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>
Personnel	\$1,102.7	\$1,172.2	\$1,241.3	\$1,330.0	\$1,354.2	\$1,449.6	\$1,496.8
Operating	333.9	358.7	348.4	411.1	423.7	402.0	391.0
Local Aid	773.9	865.2	945.3	1,008.6	1,069.7	1,098.3	1,145.0
Grants & Benefits	1,858.7	2,094.0	2,324.9	2,399.8	2,586.8	2,759.3	2,855.2
Capital	142.5	174.3	150.1	152.1	150.2	164.0	146.6
Debt Service	214.1	174.7	179.7	131.6	141.7	203.5	220.2
<i>Total</i>	<i>\$4,425.9</i>	<i>\$4,839.1</i>	<i>\$5,189.9</i>	<i>\$5,433.1</i>	<i>\$5,726.3</i>	<i>\$6,076.6</i>	<i>\$6,254.9</i>
<b>By Fund</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>
General Revenues	\$2,230.6	\$2,482.7	\$2,651.7	\$2,690.3	\$2,779.2	\$2,963.5	\$3,069.5
Federal Funds	1,283.0	1,428.8	1,465.4	1,601.5	1,760.4	1,932.0	1,966.5
Restricted Funds	144.0	96.5	92.7	117.3	134.7	116.3	104.1
Other Funds	768.3	831.2	980.0	1,024.0	1,052.0	1,064.8	1,114.7
<i>Total</i>	<i>\$4,425.9</i>	<i>\$4,839.1</i>	<i>\$5,189.9</i>	<i>\$5,433.1</i>	<i>\$5,726.3</i>	<i>\$6,076.6</i>	<i>\$6,254.9</i>
<i>Percent Change</i>	<i>7.2%</i>	<i>9.3%</i>	<i>7.2%</i>	<i>4.7%</i>	<i>5.4%</i>	<i>6.1%</i>	<i>2.9%</i>
Adjusted Expenditures	\$5,055.6	\$5,374.7	\$5,674.5	\$5,808.1	\$5,962.7	\$6,186.7	\$6,254.9
<i>Percent Change</i>	<i>3.7%</i>	<i>6.3%</i>	<i>5.6%</i>	<i>2.4%</i>	<i>2.7%</i>	<i>3.8%</i>	<i>1.1%</i>

Source: RIPEC calculations based on State Budget Office Data

Ocean State has been 4.6 percent during the same period of time (2.8 percent adjusted for inflation). Inflation has been running at 2.3 percent over this period of time.

In FY 2006, personal income growth is expected to be approximately 4.1 percent. The Governor's FY 2006 budget request increases general revenue spending by 3.6 percent (from FY 2005 revised). Therefore, over the past ten years, growth in general revenue spending has been more than twice the rate of inflation and 128.3 percent of the growth in personal income.

### **III. The Governor's Budget**

**Proposed FY 2005 Revised** - The Governor has proposed a \$6.1 billion all funds revised budget for FY 2005. While the FY 2005 enacted budget represented a 4.1 percent increase (\$233.2 million) from FY 2004 actual experience, the Governor's Revised Budget represents a 6.1 percent increase (\$350.3 million) over FY 2004 actual experience. Of the \$350.3 million increase, \$184.3 million (52.6 percent) is in

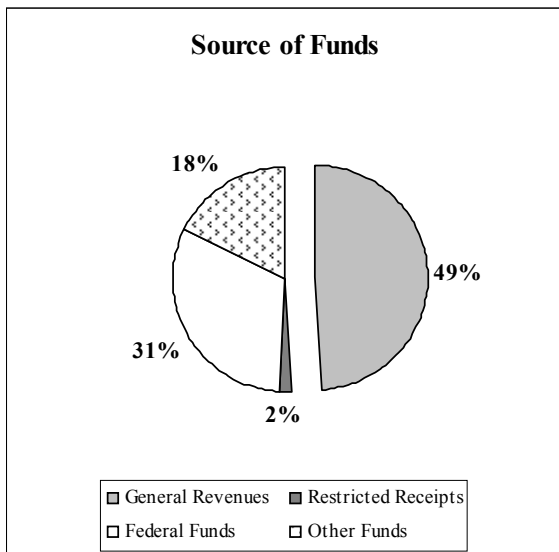
general revenues, \$171.6 million (49.0 percent) is in Federal funds and a \$5.6 million net reduction in funding a function of a reduction in restricted funds and a slight increase in other funds.

Selected changes to the FY 2005 Budget include: an additional \$2.3 million for costs associated with health insurance for retirees (assumption of 1.87 percent of salaries increased from 1.33 percent in the FY 2005 Budget as Enacted). The revised budget includes \$4.7 million in savings due to delaying the issuance of debt. The revised budget also includes an additional \$10.9 million for various medical benefits and cash assistance programs due to changes agreed upon in the November Caseload Estimating Conference. The Governor has also built \$5.5 million in savings due to proposed pension benefit reductions that would result in lower contribution rates to the State employee and teacher retirement funds.

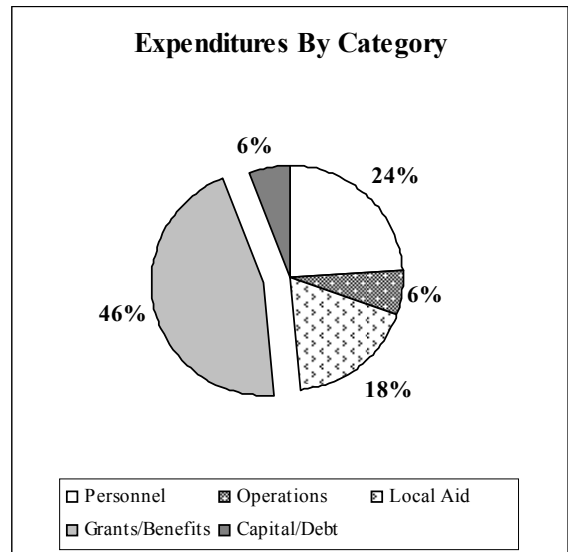
**FY 2006 Budget Summary** - The Governor has proposed a \$6.3 billion all funds budget to support State operations in FY 2006. As measured against the budget originally enacted for FY 2005 (\$6.0 billion), FY 2006 appropriations represent an increase of \$295.4 million, or 5.0 percent. Total FY 2006 expenditures are proposed to increase by 2.9 percent (\$178.3 million) over the Governor's FY 2005 Revised Budget.

FY 2006 general revenue expenditures are budgeted at \$3.1 billion, which represents a 4.5 percent (\$131.7 million) increase from the FY 2005 enacted budget and \$106.0 million more (3.6 percent) than the Governor's FY 2005 revised request.

Source of Funds: FY 2006 general revenues of \$3.1 billion represent unrestricted resources the State generates through taxes, fees and other sources, funding approximately 49.0 percent of the State budget. Federal funds of \$2.0 billion represent about 31.0 percent of the State's budget. Federal Medicaid payments account for nearly half of all Federal revenues.



Other funds, totaling \$1.1 billion in FY 2006, are primarily made up of university and college funds and employment and training funds, representing about 18.0 percent of the FY 2006 budget. Restricted funds represent the smallest resource to the State – 2.0 percent of all resources. These funds include a range of fees and charges dedicated to specific programs and activities.



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, constitute the largest category of expenditures, representing 46.0 percent of the total FY 2006 budget.

Personnel expenditures represent 24.0 percent of the State's budget, and general operations expenditures represent an additional 6.0 percent. Local aid, which includes education aid and other direct assistance to municipalities, represents 18.0 percent of the budget. The remaining 6.0 percent of the budget is dedicated to capital and debt service expenditures.

The following highlights selected expenditure and program changes.

### **Pension Initiative**

The Governor has proposed a series of changes to state employee and teacher pension benefits. The proposal establishes a minimum age to retire at 60 with 30 years of service (65 with 10 years), changes the formula for calculating benefits (reducing the maximum benefit from 80 percent to 75 percent of average final compensation) and benchmarks the COLA based on the CPI capped at 3.0 percent. These changes would apply to new hires and non-vested employees.

The Governor projects to save \$25.7 million in contributions in FY 2006 based on the pension reductions. RIPEC estimates that these changes would result in \$29.4 million in reduced pension contributions to the State in FY 2006 based on actuarial reports. Municipalities would be able to reduce contributions to the teacher pension by \$21.5 million.

### **State Aid**

The Governor has proposed an additional \$15.8 million increase in overall direct education aid, which represents a 2.5 percent increase over FY 2005 direct aid levels. In addition, the Governor has included an additional \$5.7 million for charter schools and the MET School. The FY 2006 budget includes a net increase of \$10.1 million in contributions to the teacher retirement fund and an additional \$4.7 million for the State's school construction assistance program.

For non-education aid, the Administration has included an additional \$1.0 million for the State's general revenue sharing program. However, beginning in FY 2007 and

thereafter, the Governor proposes to freeze the program at 3.0 percent of the second prior year's general tax revenues rather than phasing the program up to 4.7 percent by FY 2011 as required by current law. It is estimated that this program would require an additional \$12.0 million if it were funded based on current law. It should be noted that municipalities are still required to continue phasing out the inventory tax.

The FY 2006 budget level funds the PILOT program at \$22.7 million, reimbursing communities for 22.7 percent of foregone tax collections from tax exempt institutions rather than 27.0 percent. Funding at the 27.0 percent level would require an additional \$4.3 million, but the law does permit ratable reductions should appropriations be less than what is required to achieve 27.0 percent reimbursement. The FY 2006 budget level funds the State's car tax reimbursement at \$105.0 million for exempting \$4,500 in vehicle value from taxation.

### **Entitlements**

Because Medicaid related programs represent the majority of services provided in the State's social service system, the Governor has proposed various savings, including:

- \$1.2 million (\$0.5 million in general revenues) from enhanced capacity to perform cost avoidance and third party reviews of Medicaid fee-for-service pharmaceuticals.
- \$2.0 million (\$0.9 million in general revenues) from revising reimbursement schedules for certain diagnoses for RIte Care clients in order to avoid more expensive emergency room care rates.

- \$1.9 million (\$0.9 million in general revenue) from a set of adjustments to recovery procedures from estates of persons accessing Medicaid coverage. This initiative includes the addition of 1.0 FTE position in FY 2006.
- \$4.7 million (\$2.1 million general revenues) from a supplemental drug rebate for fee-for-service Medicaid clients.
- \$1.8 million (\$0.8 million in general revenues) from transitioning all eligible RIte Care clients to any available employer-sponsored health insurance coverage.

### **Other Budget Proposals/Actions**

The Governor has proposed a \$54.0 million moral obligation bond for various economic development activities, which includes \$25.0 million for a land assembly initiative (“Jump Start”), \$10.0 million for a small and minority business growth fund, \$15.0 million for the Slater Fund and the \$4.0 million balance for a Northern Rhode Island Bio-technology Facility.

The FY 2006 budget includes tuition increases of 8.8 percent at the University of Rhode Island, 8.6 percent at Rhode Island College and 8.9 percent at the Community College of Rhode Island.

The Governor has proposed to allocate \$39.4 million of the State Capital Plan Fund for debt service in FY 2006, which is \$20.6 million more than FY 2005. This will result in less pay-as-you-go financing of capital projects.

**Personnel Trends** – FY 2006 personnel expenditures total \$1,496.8 million, a \$47.2 million (3.3 percent) increase from the FY 2005 revised personnel budget. The majority of the net increase in personnel spending was driven by an additional \$45.5 million in benefits.

General revenues support 51.6 percent of all personnel expenses in FY 2006. Federal Fund support nearly 22.5 percent and the remaining funds (special funds, restricted receipts and internal service funds) support 25.9 percent of the personnel budget.

The FY 2005 Revised Budget includes an additional \$26.3 million net in personnel spending than was enacted last summer. The Administration has requested an additional \$20.8 million in expenditures for purchased services, increasing enacted expenditures from \$177.4 million to \$198.2 million in the FY 2005 Revised Budget. This was primarily driven by additional expenditures in management and audit services (\$9.9 million).

The FY 2005 Revised Budget includes an additional \$9.2 million for overtime expenditures and \$4.3 million more for temporary and seasonal employees. As RIPEC has noted over the past several fiscal years, the additional expenditures for purchased services may be partially due to consistent under-budgeting of these expenses in the budget process (discussed further below).

Personnel expenditures represent a significant portion of the State’s budget. In FY 1996 (adjusted for inflation), personnel spending represented 26.5 percent of the State budget. It has since declined to 23.9 percent of the budget, principally due to faster growth in grants and benefits to individuals and local aid.

**Table 4**  
**State Personnel Costs - Unadjusted**

Personnel Costs (Millions)	FY 2003	FY 2004	FY 2005	FY 2006	<i>FY 2006 - FY 2005 Revised</i>	
	Actual	Actual	Revised	Proposed	Actual Change	Percent Change
<b>Salaries &amp; Benefits</b>						
Net Salaries	\$801.4	\$794.6	\$824.6	\$852.1	\$27.5	3.3%
Adjustment for Temp	(\$81.7)	(\$83.3)	(\$71.2)	(\$73.8)	(2.6)	3.7%
Overtime	58.5	61.3	56.7	47.3	(9.4)	-16.6%
Retirement	67.4	79.1	94.1	120.6	26.5	28.2%
Medical	136.4	149.7	166.8	183.8	17.0	10.2%
Other Benefits/Payroll	75.7	74.0	79.4	81.4	2.0	2.5%
<i>Salaries &amp; Benefits</i>	<i>\$1,057.6</i>	<i>\$1,075.4</i>	<i>\$1,150.5</i>	<i>\$1,211.5</i>	<i>\$61.0</i>	<i>5.3%</i>
<b>Funded FTE Positions</b>	<b>15,401.0</b>	<b>15,289.4</b>	<b>15,901.6</b>	<b>15,975.0</b>	73.4	0.5%
<b>Average Cost Per FTE</b>	<b>\$68,673</b>	<b>\$70,336</b>	<b>\$72,353</b>	<b>\$75,836</b>	3,483.0	4.8%
<b>Other Personnel Costs</b>						
Other Payroll Costs	\$109.6	\$111.1	\$100.9	\$105.0	\$4.1	4.1%
Purchased Services	162.7	167.7	198.2	180.3	(17.9)	-9.0%
<i>Other Personnel</i>	<i>\$272.3</i>	<i>\$278.8</i>	<i>\$299.1</i>	<i>\$285.3</i>	<i>(\$13.8)</i>	<i>-4.6%</i>
<b>Total Personnel Costs</b>	<b>\$1,329.9</b>	<b>\$1,354.2</b>	<b>\$1,449.6</b>	<b>\$1,496.8</b>	<b>\$47.2</b>	<b>3.3%</b>

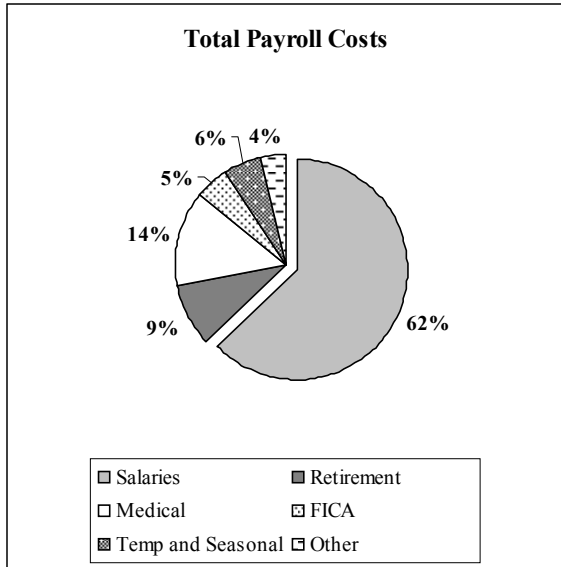
Source: State Budget Office and FY 2006 Personnel Supplement.

Personnel expenditures increased by \$557.8 million from FY 1996 to FY 2006 – a 59.4 percent increase over this period of time. If one adjusts these expenditures for inflation (2006 dollars), personnel expenditures increased by \$319.6 million, or by 27.1 percent.

The average cost per FTE position increased by 62.0 percent over this period. The average cost increased from \$46,869 in FY 1996 to \$75,840 per position in FY 2006. If one adjusts FY 1996 expenditures per position for inflation, the average cost per FTE position has increased from \$56,524 in FY 1996 to \$75,840 per position in FY 2006 – a 29.0 percent increase during this period. This growth is attributed to increases in the salary base, pension contributions, medical insurance costs, and cost of living arrangements in the State’s contracts.

Providing medical insurance to State employees has doubled since FY 1996. Employee medical insurance costs have increased from \$85.2 million in FY 1996 to \$183.8 million in FY 2006. Adjusting for inflation, medical insurance costs increased from \$106.8 million in FY 1996 to \$183.8 million in FY 2006 – a \$77.0 million or 72.1 percent in real growth.

Another growing cost in the State budget is the State’s pension obligations. Without any changes, the State’s actuarial contribution for state employee retirement is projected to increase from 11.51 percent of wages and salaries in FY 2005 to 16.96 percent in FY 2006 - increasing the State’s contribution by \$38.3 million. Projections indicate that the State’s contribution rate will reach 21.63 percent by FY 2010.

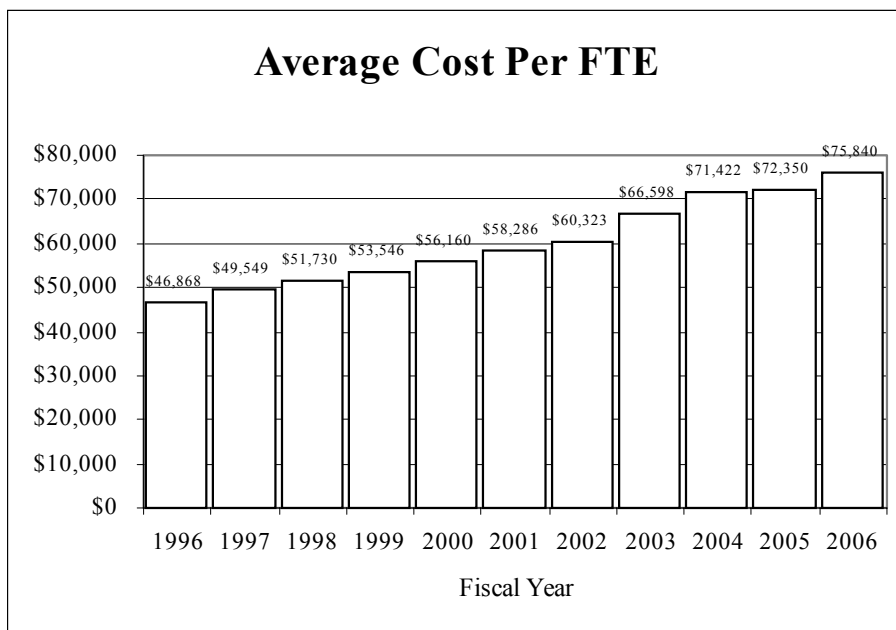


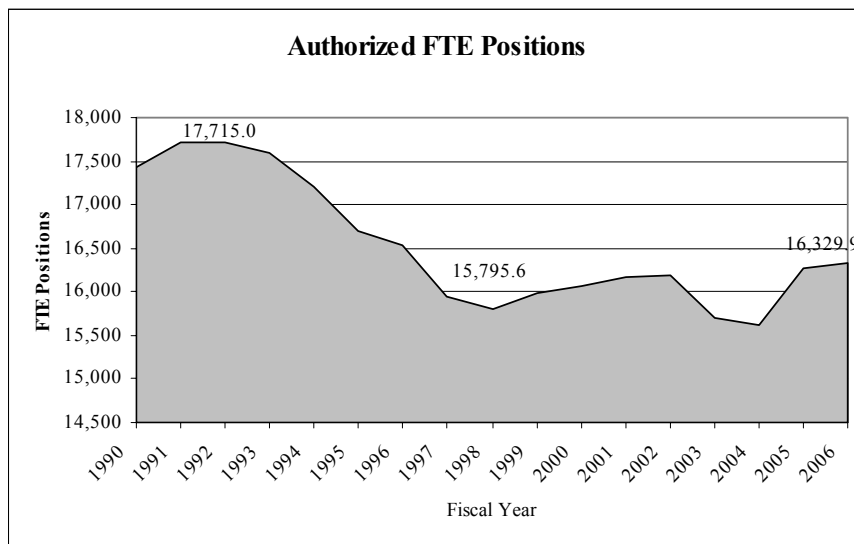
A similar impact would be felt for the employer contributions to the teacher retirement system, where the actuarial contribution teacher pensions is projected to increase from 14.84 percent in FY 2005 to 20.02 percent in FY 2006, requiring \$51.2 million more in state and local contributions (State portion projected at \$20.5 million). Projections indicate that the total employer contribution for teacher pensions will reach 24.89 percent of wages and salaries by FY 2010.

The FY 2006 personnel budget includes the Governor's initiative to reduce pension benefits for new state employees and those who are not vested in the system. The Administration has included \$25.7 million in a net reduction in pension contributions as a result of the pension benefit reductions.

*Staffing* - In order to manage the staffing levels in State government, 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 analysis includes these positions in the totals for comparison purposes.

The Governor's FY 2005 Revised Budget request includes 16,265.5 FTE positions, representing a net increase of 38.3 FTE positions from the FY 2005 enacted budget. It should be noted that this figure includes 781 FTE positions in higher education that have been designated as exempt from the enacted FTE authorizations.





The Governor's FY 2006 Budget includes 16,329.9 FTE positions, representing a 64.4 FTE position increase from the FY 2005 Revised Budget. This figure includes 785.0 FTE positions in higher education that have been designated as exempt from the enacted FTE authorizations. Among the net increase, positions are proposed for higher education to enhance the nursing and pharmacy programs as well as increased staff at the Newport CCRI campus.

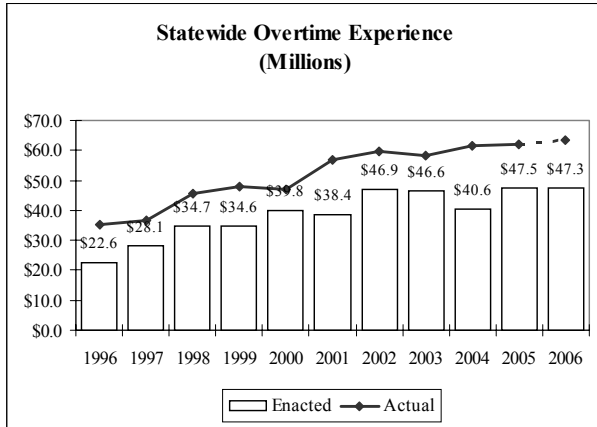
*Other Personnel Issues* – RIPEC believes two other issues require attention. Overtime expenditures continue to display trends that raise some questions. Overtime expenditures represent approximately 5.0 percent of the State's salaries and benefits. Overtime has increased from \$35.1 million in FY 1996 (unadjusted) to a FY 2006 request of \$47.3 million – a \$12.2 million increase during this period (34.8 percent). Overtime expenditures peaked at \$61.3 million in FY 2004.

However, what is of concern is the ongoing practice of how overtime is budgeted. In FY 2004, actual experience in overtime expenditures (\$61.3 million) exceeded the enacted appropriation of \$40.6 million by 51.0 percent. Similarly, the FY 2005

enacted budget included \$47.4 million in overtime, whereas the Governor's FY 2005 Revised Budget includes \$56.7 – a 20.0 percent increase from the enacted budget. The FY 2006 proposed budget includes \$47.3 million in net overtime expenditures. This would represent a \$9.4 million decrease in overtime expenditures from the Governor's FY 2005 Revised Budget – a 16.6 percent decrease in overtime spending.

Since FY 2001, overtime expenditures have been around \$60.0 million annually, whereas the budget requests during this period of time have averaged around \$46.0 million annually. In other words, actual overtime experience has consistently exceeded requested appropriations by 30.0 percent since FY 2001.

Purchased services also have a number of interesting expenditure and budgeting trends. First, expenditures have increased from \$89.3 million in FY 1996 to \$180.3 million in FY 2006 – a \$91.0 million increase. If one adjusts for inflation, purchased services still increased by \$68.3 million or 61.0 percent. Purchased services expenditures represented 9.5 percent of the State's personnel budget in FY 1996. This has since increased to 12.0 percent.



A similar pattern experienced in overtime emerges in purchased services. In FY 2005, the Budget as Enacted included \$177.4 million in contract spending. Of this amount, \$51.3 million was supported with general revenues. The Governor has requested \$198.2 million in spending for these services in the revised FY 2005 budget plan – a \$20.8 million net increase from the enacted budget (an 11.7 percent increase). Of this amount, \$49.7 million would be supported with general revenues.

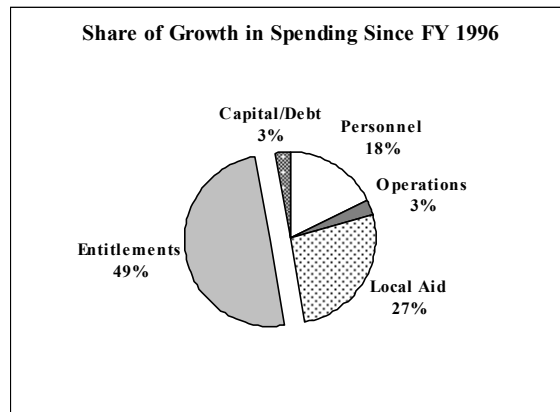
The Governor’s FY 2006 budget request includes \$180.3 million in expenditures for contracted services, of which \$55.6 million is supported with general revenues.

There are two areas within purchased services that have experienced the most growth in spending over time. First, Management and Audit services increased from \$51.0 million in the enacted FY 2005 budget to \$60.8 million in the FY 2005 revised spending plan and are proposed to return to \$50.6 million in the FY 2006 proposed budget.

**Grants and Benefits** – Expenditures relating to direct assistance to individuals are considered grants and benefits in the State’s operating budget. These expenditures include medical assistance,

employment security and temporary disability funds, food stamps, and other cash assistance.

Total grant and benefit expenditures (adjusted for inflation) increased by \$899.0 million from FY 1996 to FY 2006 – a 46.0 percent increase over this period of time. The \$899.0 million increase in grants and benefits represented nearly 50.0 percent of the total growth in State spending during this period of time.



Of the \$899.0 million increase from FY 1996 to FY 2006, \$603.0 million – or 67.1 percent – was associated with medical assistance programs, such as RIte Care and nursing homes. This growth has been a function of demographic shifts in the State, medical price inflation, and public policy decisions to expand eligibility and services to more Rhode Islanders.

FY 2006 Medicaid expenditures will total \$1.9 billion, accounting for 30.0 percent of the State’s total budget. Medicaid expenditures have increased by 67.7 percent since FY 2000, increasing from \$1.1 billion to \$1.9 billion during this period of time. Table 5 provides a summary of Medicaid expenditures within the Department of Human Services, representing approximately 70.0 percent of the State’s entire Medicaid expenditures in FY 2006.

**Table 5**  
**FY 2000 - 2006 Medical Assistance Expenditures**

	FY 2000	FY 2005	FY 2006	FY 2000 - 2006 Change		2006 CEC -2006 Change	
	Audited	Enacted	Rec	\$	%	\$	%
Hospitals	84.3	\$123.8	\$143.0	\$58.7	69.6%	(\$1.0)	-0.7%
DSH	59.9	108.0	103.5	\$43.6	72.8%	0.0	0.0%
Nursing Homes	245.6	307.3	307.7	\$62.1	25.3%	(0.8)	-0.3%
Managed Care	190.3	389.5	440.3	\$250.0	131.4%	(4.7)	-1.1%
Other	121.0	234.1	276.2	\$155.2	128.3%	(11.8)	-4.1%
Special Ed	20.0	35.0	38.5	\$18.5	92.5%	0.0	0.0%
<b>Total</b>	<b>721.1</b>	<b>1,197.7</b>	<b>1,309.2</b>	<b>\$588.1</b>	<b>81.6%</b>	<b>(\$18.3)</b>	<b>-1.4%</b>
<b>Gen Rev</b>	<b>334.4</b>	<b>534.8</b>	<b>593.9</b>	<b>\$259.5</b>	<b>77.6%</b>	<b>(\$18.1)</b>	<b>-3.0%</b>

\*The Caseload Estimating Conference (CEC) does not calculate disproportionate share payments to hospitals for which there is no current law provision. To make expenditures comparable, the Governor's recommendation in DSH payments of \$103.5 million has been added to CEC estimates.

Source: State Budgets, House FY 2006 Budget Report and RIPEC calculations.

*Caseload Trends* – The State conducts two caseload estimating conferences annually to project caseloads for selected programs as well as certain expenditures. Table 6 summarizes the trends in caseloads from FY 1996 through and including the Governor's FY 2006 budget.

RIte Care enrollments increased from 71,076 in FY 1996 to a projected 133,742 in FY 2006 - an 88.2 percent increase over this period of time, with an average annual rate of growth of 6.5 percent (The caseload estimating conference does not forecast RIte Care enrollments).

The State's Supplemental Security Income (SSI) population has increased from 24,328 in FY 1996 to 31,000 in FY 2006 – representing a 27.4 percent increase during this period of time. This translates to an average annual rate of growth of 2.5 percent.

*Family Independence Program (FIP)* – In 1996 the Aid to Families with Dependent Children Program (AFDC) was replaced by the Family Independence Program (FIP) to implement the Temporary Assistance to Needy Families (TANF) block grant.

The FIP is designed to reduce the welfare roles, and make families economically self-sufficient by moving them from welfare to work. The FIP has a lifetime limit of 60 months for cash assistance for adults.

There are two major components of FIP – direct cash assistance and a child care subsidy. In FY 1996, the State spent \$181.5 million on the program (adjusted for inflation), of which \$161.3 million (89.0 percent) was in support of cash assistance and \$20.2 million (11.0 percent) for child care subsidies.

In FY 2006, the Governor has requested \$146.2 million for the program, of which \$67.3 million (46.0 percent) is related to cash assistance and \$78.9 million (54.0 percent) for child care subsidies. The FY 2006 budget represents a \$35.3 million reduction in total spending for the program since FY 1996 (adjusted).

Overall, the State is projected to provide approximately 44.7 percent (\$65.4 million) of the funding for the programs in FY 2006. For the cash assistance program, the State provides 15.0 percent (\$10.1 million) of the funding and the Federal government provides the 85.0 percent (\$57.2 million)

balance. However, the child care program funding structure is considerably different, where the State provides 70.0 percent of the funding and the Federal government the balance.

The reduction in cash assistance for FIP is due to a continued decline in projected enrollment. In FY 1996, there were 58,400 persons enrolled in the TANF program. Caseloads are projected to be 34,850 with no changes in policy. This represents a 40.3 percent decline in caseloads during this period of time. The Governor's budget assumes an estimated caseload of approximately 33,900 in FY 2006, representing a projected 946 net decrease from the November estimate due to proposed changes in the FIP program.

Conversely, the portion of the program allocated for child care has increased by \$58.7 million from FY 1996 to FY 2006 (adjusted for inflation). This represents a 290.6 percent increase during this period. Child care slots have increased from 4,983 in FY 1996 to a projected 13,350 in FY 2006 based on the November caseload estimating conference. Therefore, caseloads have increased by 167.9 percent, or at an average annual rate of 10.4 percent during this period of time.

The Governor's budget includes provisions to reduce general revenue cash assistance costs by \$2.1 million by advancing sanctions against families with parents in non-compliance with employment plans from 24 to 12 months, and by requiring completion of an employment plan before establishing initial FIP eligibility payments (both initiatives result in decreasing FIP caseload by approximately 947 persons).

**Table 6**  
**Selected Caseload Trends FY 1996 - FY 2006**

Fiscal Year	Child Care	Rlte Care**	TANF	SSI	GPA	Food Stamps	Prisons
1996	4,983	71,076	58,405	24,328	1,085	0	3,002
1997	6,066	75,484	54,783	25,153	847	0	3,240
1998	6,830	74,853	54,287	25,318	485	4,236	3,392
1999	8,206	94,510	53,243	26,156	576	3,201	3,384
2000	10,553	105,504	51,487	27,162	651	2,545	3,196
2001	11,795	107,526	47,764	28,050	699	2,320	3,019
2002	12,107	116,393	45,180	28,916	400	2,266	3,387
2003	13,057	120,896	42,364	29,008	468	2,140	3,537
2004	13,601	127,828	40,302	29,645	429	0	3,600
2005 CEC*	13,415	no estimate	37,700	30,390	406	0	no estimate
2005 Gov	12,879	129,076	36,259	30,350	460	0	3,377
2006 CEC/Gov	13,350	133,742	33,904	31,000	415	0	3,244
1996-2006	8,367	62,666	(24,501)	6,672	(670)	0	242
Change	167.9%	88.2%	-42.0%	27.4%	-61.8%	0.0%	8.1%
Av. Ann. Rate	10.4%	6.5%	-5.3%	2.5%	-9.2%	0.0%	0.8%

\*CEC= Caseload Estimating Conference (The CEC does not estimate Rlte Care enrollment and prison caseloads)

\*\*Rlte Care caseload includes caseload for Rlte Share and children with special health care needs in managed care.

Source: DHS, FY 2006 State Budget Documents, November 2004 Caseload Estimating Conference, and RIPEC calculations.

**Table 7**  
**Aid to Local Units of Government**  
(Millions)

<b>State Aid</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2005-06</b>
Direct Education Aid	\$596.4	\$621.7	\$637.6	\$641.7	\$657.5	\$15.8
Teacher Retirement	30.7	38.2	46.2	48.5	58.6	10.1
Construction Aid	33.2	38.2	40.7	42.2	46.9	4.7
Motor Vehicle Reimbursement	99.6	101.3	104.8	105.0	105.0	0.0
General Revenue Sharing	43.6	48.3	51.4	52.4	53.4	1.0
PILOT	18.1	18.2	21.7	22.7	22.7	0.0
Distressed Community	7.7	8.1	7.5	8.5	8.5	0.0
Library Aid	6.3	6.6	7.6	8.1	8.4	0.4
MET School	2.2	4.0	5.8	7.3	8.8	1.6
Charter Schools	6.2	10.0	13.3	17.9	22.1	4.2
Other State Aid - Various	21.1	7.2	10.6	9.5	9.3	(0.2)
Federal Aid	80.3	106.8	122.4	134.5	143.7	9.2
<b>Total State Aid</b>	<b>\$945.3</b>	<b>\$1,008.6</b>	<b>\$1,069.6</b>	<b>\$1,098.3</b>	<b>\$1,145.0</b>	<b>\$46.7</b>
<i>Change</i>	<i>9.3%</i>	<i>6.7%</i>	<i>6.1%</i>	<i>2.7%</i>	<i>4.3%</i>	

Source: RIPEC calculations based on State Budget Office Documents

**State Aid** - The Governor's FY 2006 budget request includes approximately \$1,145.0 million in local aid, representing a 4.3 percent increase over the FY 2005 Revised Budget (\$1,098.3 million). Approximately 66.6 percent of the \$1,145.0 million in local aid program is related to general school aid. This is down from 85.4 percent in FY 1996.

Local aid to cities and towns has doubled since FY 1996 - from \$528.5 million to \$1,145.0 million in FY 2006 as proposed by the Governor - a \$616.5 million increase over this period of time. If one adjusts for inflation, local aid increased from \$662.6 million in FY 1996 - a \$482.4 million increase in local aid during this period. It should be noted that the growth in local aid since FY 1996 represents 26.7 percent of all State spending growth during this period.

The four largest drivers of growth in local aid include the program to phase-out the excise tax on motor vehicles, education aid, Federal aid (primarily for schools) and general revenue sharing.

As shown on Table 2 (page 12), of the \$482.4 million net increase in local aid since FY 1996 (adjusted for inflation), nearly 40.9 percent of the increase was for additional education aid, and 21.8 percent (\$105.0 million) was related to the program to phase out the excise tax on motor vehicles. Approximately 20.9 percent is related to various Federal aid programs for local communities and 7.8 percent was due to increases in general revenue sharing. The 8.6 percent balance was in various other state aid programs.

Education Aid - The Governor's FY 2006 education aid program totals \$797.7 million, representing a \$36.4 million (4.8 percent) increase over FY 2005 revised figures. Education aid includes all direct funding allocated to school districts, including Central Falls. There are several components to the Governor's program worth noting. First, the direct education aid program would total \$657.5 million - a \$15.8 million increase from FY 2005, representing 43.4 percent of the net increase in education aid.

The second largest increase in the education aid package is for the State's contribution for the teacher retirement fund. The Governor has included an additional \$10.1 million in State contributions, which is net of savings the State would derive from the Governor's pension reduction proposal.

The Governor has increased funding for charter schools and the MET school by \$5.8 million. The Budget also provides an additional \$4.7 million for the State's Construction Aid program.

Payment-in-Lieu-of-Taxes - Established in 1986, PILOT is designed to provide payments to municipalities for various institutions that are not on property tax rolls. Prior to FY 2003, the program provided a 27.0 percent reimbursement rate for taxes that were foregone due to the property's tax exempt status. The FY 2003 budget included language to permit the State to ratably reduce the appropriation for the PILOT program rather than to appropriate to the statutorily established rate of 27.0 percent.

The Administration has proposed level-funding PILOT at \$22.7 million, which would represent funding at 22.7 percent of property taxes foregone at the local level. To continue funding at the 27.0 percent level would require an additional \$4.3 million.

General Revenue Sharing - The program distributes aid to municipalities based on the percentage of total state tax collections from two years prior. In FY 1999, the State started to eliminate local retail, wholesale and auto dealers' inventory taxes over a ten-year period, freezing FY 1999 local tax rates and requiring municipalities to reduce rates annually by 10.0 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. Since its inception the program has experienced a two-year delay in its implementation – scheduled to be fully implemented by FY 2011.

Under current law, FY 2006 General Revenue Sharing aid would be calculated based on 3.0 percent of FY 2004 total tax revenues. This would require an appropriation of approximately \$65.3 million. However, the Governor has proposed to fund the program at \$53.4 million, or at 2.5 percent. The Governor has also proposed to permanently establishing the program at 3.0 percent in FY 2007 and thereafter.

Phase-out of the Excise Tax on Motor Vehicles – In FY 1999, the State embarked on an eight-year program to phase-out the excise tax on motor vehicles by FY 2007. The program required 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 was exempt by FY 2007. In making up the lost revenues generated by the tax, the State holds communities harmless through advance reimbursements adjusted for inflation.

The Governor has continued the freeze on the eight-year phase out of the local excise tax on motor vehicles. The FY 2006 budget continues to reimburse local communities for an exemption of \$4,500, requiring \$105.0 million.

## IV. The Revenue Plan

The Governor's FY 2005 Revised Budget and FY 2006 proposed budget are based on revenue estimates established in November 2004. It should be noted that the November 2004 Revenue Estimating Conference (REC) increased FY 2005 revenue estimates by \$22.9 million – from \$2,954.4 million to \$2,977.3 million.

The REC estimated revenues of \$3,033.1 million for FY 2006. This is a net increase of \$56.3 million from the revised revenues for FY 2005 (\$2,976.8 million). However, the FY 2006 estimates did not include the Hospital Licensing Fee - estimated to be \$64.4 million. The Governor and General Assembly have extended the fee each year. As shown on the next page the Governor recommended continuing the Hospital Licensing Fee.

The Governor has proposed changes to the revenue plan for both fiscal years. The Governor's proposed FY 2005 changes amount to a reduction of \$0.5 million.

The Governor's FY 2006 changes total \$89.3 million. However, if one excludes the Hospital Licensing Fee of \$64.4 million (apparently reauthorized each year), the Governor's FY 2006 revenue plan increases total revenues by \$24.9 million. Of this increase, \$16.8 million are additional revenues generated from taxes and fees and \$8.1 million is from other sources.

Major revenue changes include, but are not limited to:

- \$64.4 million in revenue through the extension of the hospital licensing fee (rate of 3.45 percent of net patient service revenues);

- \$7.7 million in additional revenues for judicial receivables;
- \$4.5 million transfer from the Resource Recovery Corporation;
- \$3.1 million in additional insurance gross premiums through Beacon Mutual Exemption Repeal;
- \$3.9 million in various increases in tax revenues, including the shift of the cigarette sales tax to distributors and motor vehicle fee increases; and
- \$2.0 million in additional revenues from a transfer from the Underground Storage Tank fund.

The following discussion highlights selected revenue changes:

Hospital Licensing Fee – The Governor has recommended extending the licensing fee in FY 2006 at 3.45 percent of net patient service revenues. This is projected to generate \$64.4 million in gross revenues to the State, where nearly 95.0 percent (\$60.6 million) would be generated from community hospitals and the balance from the Eleanor Slater Hospital. The community hospitals are projected to receive \$27.2 million more in uncompensated care payments than they pay in hospital fees to the State.

Beacon Mutual Insurance Gross Premiums Tax – The Governor recommends removing the exemption for the Beacon Mutual Insurance Company from the 2.0 percent gross insurance premiums tax.

Judicial Receivables – The Governor’s budget includes \$7.7 million based on projected collections of outstanding fines, penalties and court costs.

RIPAE Rebates – The FY 2006 budget includes a Fiscal Fitness proposal to implement a 340B pharmacy program in the State. The 340B pharmacy program allows for the negotiation of pharmaceutical rebates from drug manufacturers that supply prescription drugs to the State’s RIPAE program, resulting in projected rebates of \$1.3 million in FY 2006. These savings are offset by a \$0.7 million reduction in pharmaceutical rebates through the implementation of the Federal Medicare drug card program. The Federal discount card provides \$600 of a drug benefit for qualifying elderly individuals, affecting an estimated 7,000 program members.

Additional Tax Revenues – The Governor’s budget includes \$3.9 million in various increases in tax revenues. Approximately \$1.9 million revenues will come from additional sales tax revenues by requiring that cigarette distributors pre-pay the state sales tax when purchasing cigarette tax stamps. The increase in Motor Vehicle fees is attributable to the Governor’s proposal to increase select driver’s license, registration, and other fees to be more cost effective.

**Table 8**  
**State General Revenues**

General Revenues	FY 2005		Governor FY 2005R		FY 2006		Governor FY 2006	
	REC	Governor	Change	Percent	REC	Governor	Change	Percent
<b>Taxes</b>								
Personal Income Tax	\$949.9	\$949.9	\$0.0	-	\$999.2	\$999.3	\$0.1	0.0%
General Business Taxes	263.0	263.0	0.0	-	272.0	275.5	3.5	1.3%
General Sales & Use Tax	864.0	864.0	0.0	-	904.2	906.1	1.9	0.2%
Cigarette Tax	137.5	137.5	0.0	-	126.1	126.1	0.0	0.0%
Other Taxes	104.6	104.6	0.0	-	107.0	108.6	1.5	1.4%
<i>Subtotal - Taxes</i>	<i>2,319.0</i>	<i>2,319.0</i>	<i>0.0</i>	<i>-</i>	<i>2,408.5</i>	<i>2,415.5</i>	<i>7.0</i>	<i>0.3%</i>
Department Receipts	297.0	296.7	(0.3)	-0.1%	238.0	312.2	74.2	31.2%
<b>Taxes &amp; Departmentals</b>	<b>\$2,616.0</b>	<b>\$2,615.7</b>	<b>(\$0.3)</b>	<b>0.0%</b>	<b>\$2,646.5</b>	<b>\$2,727.7</b>	<b>\$81.2</b>	<b>3.1%</b>
<b>Other Sources</b>								
Gas Tax Transfer	\$9.6	\$9.6	\$0.0	0.0%	\$9.6	\$11.7	\$2.1	22.2%
Other Miscellaneous	16.8	16.8	0.0	0.0%	8.5	15.0	6.5	76.8%
Lottery	318.0	318.0	0.0	0.0%	356.7	356.7	0.0	0.0%
Unclaimed Property	17.0	16.8	(0.2)	-	11.8	11.3	(0.5)	-
<i>Total Other Sources</i>	<i>361.4</i>	<i>361.1</i>	<i>(0.2)</i>	<i>-0.1%</i>	<i>386.6</i>	<i>394.7</i>	<i>8.1</i>	<i>2.1%</i>
<b>Total Gen. Revenues</b>	<b>\$2,977.3</b>	<b>\$2,976.8</b>	<b>(\$0.5)</b>	<b>0.0%</b>	<b>\$3,033.1</b>	<b>\$3,122.4</b>	<b>\$89.3</b>	<b>2.9%</b>

REC= Revenue Estimating Conference

Source: FY 2006 State Budget, Executive Summary, November 2003REC, and RIPEC calculations