The Economic Progress Institute

Protecting Rhode Islanders and the Economy: How to Cover Rhode Island's Revenue Shortfall

INTRODUCTION

With the economic fallout from the COVID-19 crisis, Rhode Island faces an estimated revenue shortfall of at least $617.7M for FY2021.[1] As policymakers design the state's FY2021 budget, they will consider this shortfall and means of addressing it. Contrary to claims that cutting spending will prove an absolute necessity, policymakers have options for avoiding destructive cuts — cuts that will disproportionately harm Black and Latinx households, which have been hit hardest by both the public health and financial crises of COVID-19.[2] Furthermore, evidence from the Great Recession a decade ago clearly shows that where states made severe cuts, the economy slowed and emergence from recession took longer.

Despite the size of the estimated revenue shortfall, it is possible to make up for hundreds of millions of dollars without slashing services and pushing more people into unemployment. Ideally, the federal government will come through with additional relief, or with fewer restrictions on aid already provided, yet this outcome remains uncertain. Federal aid or not, however, we need to think about the longer term and be smart about revenue going forward, so that in FY2022 and beyond we do not face continuing threats of big cuts. Absent a new COVID-19 relief package from Washington, D.C., avoiding harmful state budget cuts remains possible — through revenue raising, revenue preservation, carefully targeted borrowing, and the use of existing federal aid.

REVENUE RAISING

Generic claims that everyone has been hurt by COVID-19 mask the fact that the impact has been strikingly uneven. True, everyone has been inconvenienced in one way or another, yet some have suffered much more than others—by death, illness, unemployment, or loss of income. And yet, despite the unprecedentedly high unemployment rates, many individuals and households have maintained their pre-crisis incomes, as shown by the U.S. Census Bureau's Household Pulse survey; from mid-July looking back to mid-March, 48.7% of workers nationally and 45.4% of workers in Rhode Island reported no loss of employment income.[3] A modest increase on the marginal income tax rate for the top 1% of taxpayers (who often maintain considerable wealth in addition to high earnings), would raise valuable revenue from those most able to afford it (and those who are much more likely to be able to work remotely and keep safer from COVID-19 infection, while others must take greater risks). Legislation introduced by Senator Conley and Representative Alzate would raise an estimated $128.2 million by increasing the top marginal personal income tax rate from 5.99% to 8.99% on taxable income above $475,000.[4] Such taxpayers have also benefitted disproportionately and continue to benefit from lower federal tax rates on capital gains income, as well as two decades of federal and state tax breaks for the wealthiest among us.

REVENUE PRESERVATION

In FY2020, the General Assembly (GA) withdrew $120 million from the Budget Reserve and Cash Stabilization Account, also known as the Rainy Day fund. Current law requires the GA to pay this same amount into the Rhode Island Capital Plan (RICAP) fund during FY2021. However, a decade ago, the last and only other time the GA withdrew such funds, it delayed repayment by a year. It ought to do so again this year. The rainy day continues, and these revenues are needed for more immediate and urgent purposes. If necessary, the state can employ some of the funds borrowed through the November ballot measures to cover shortfalls in critical capital spending. It is also worth noting that there remains $77.3 million in the Rainy Day fund, with 3% of FY2021 general revenue being set aside on top of this, meaning that there will be close to $200 million in the Rainy Day fund this fiscal year; as it is still raining, consideration should be given to withdrawing some additional funds later this fiscal year, when they might very well be needed, and pay back the funds only after the recovery gets into gear.

Another means of preserving revenue would be to freeze the car tax phase out at FY2020 levels. In phasing out this local tax, the state took on the obligation to make the municipalities whole, dollar for dollar, for this substantial loss of revenue. For FY2020, the reimbursement surpassed $80 million, and if left to proceed according to schedule, the cost will pass $100 million in FY2021, and reach close to a quarter-billion dollars in FY2024, once the phase out is complete — and this cost will remain an annual appropriation. Furthermore, much of the benefit of the phase out has already gone to those individuals who needed it most. For example, a car valued at $3,000 or less is now fully exempted from the tax. Anyone with a car valued at $10,000 now pays no more than $200 per year. As the phase out continues, the benefits will accrue more and more to the wealthiest Rhode Islanders, to those with the most cars and the most expensive cars. In addition, individuals who do not own cars have experienced no tax relief and will never receive this tax relief, while paying sales and income taxes that support the state payments to local governments.

BORROWING

With voter approval of referendums on the November ballot, the state aims to borrow funds for housing and other capital projects. However, additional options for borrowing remain. Without endorsing any particular option, these are some of the alternatives: designating special entities to borrow for specific purposes; selling bonds to the new Municipal Liquidity Facility created by the Federal Reserve Bank to assist municipalities and states; selling bonds secured by future expected revenue (as is sometimes done, for example, with bridge and highway tolls); and issuing “Human Capital Bonds” as investments in education and possibly other areas. Borrowing at today’s low rates provides the opportunity to invest wisely in people, jobs and retraining, and education, to keep the local economy moving and to build the sort of infrastructure that makes Rhode Island a wonderful place to live and to grow businesses.

FEDERAL AID

Because the federal COVID-19 emergency declaration has been extended into October, states will receive an increased FMAP rate, for federal matching Medicaid dollars, through the end of the calendar year. For Rhode Island, this amounts to an estimated $83.2 million in federal funds for the first half of the state’s 2021 fiscal year and will increase if the emergency declaration continues even a single day into the new calendar year.

In June 2020, the GA passed a supplemental FY2020 budget that substituted $97.3 in federal funds for state expenditures on COVID-related needs in public health, public safety, and education. The federal funds came from the $1.25 billion in aid provided to Rhode Island through the Coronavirus Aid, Relief, and Economic Security (CARES) Act. With ongoing public health needs and the challenges posed by the start of the new school year, such coronavirus-related response efforts have continued into FY2021, and enough funds remain from the CARES Act aid to cover at least the same amount of spending for necessary expenditures at least through the end of December 2021.

THE CYCLICAL ECONOMY: CUTS VS INVESTMENTS

Revenue raising, revenue preservation, borrowing, and federal aid — these alternatives to cutting state spending are important because of the harm caused by spending cuts put in place during a recession in a cyclical economy. Most simply stated, a recession is a decline in economic activity, often measured as the Gross Domestic Product (GDP) and also involving employment and consumer demand. A recession features a drop in aggregate demand for products and services, as well as a substantial loss of jobs. The COVID-19 recession is unusual in that, for public health reasons, we do not actually want everyone going back immediately to their pre-pandemic work; for instance, we do not want to operate restaurants at full capacity right now, because doing so would worsen the pandemic and kill more people and further damage the economy and delay recovery.

With this basic framework in mind, it becomes clear that an austerity-driven budget will only slow the economy further, resulting in the loss of additional jobs and causing drops in consumer demand and GDP — and in a cyclical manner, so that the declines feed upon each other in a downward spiral. To soften and escape a recession, it is critical to maintain or increase investment in people and jobs. And the most efficient ways to accomplish this are through direct spending, whether through benefits for those who cannot work and for those who face food and housing insecurity or through preserving and creating jobs, including investments in retraining the workforce.

That austerity and stimulus produce very different results is not simply a matter of common sense or theory. There is strong evidence, including from the Great Recession of a decade ago. For example, a recent analysis from the Economic Policy Institute demonstrates that states which maintained their public employment levels during the Great Recession experienced on average a return of private employment to pre-recession levels a year and a half more quickly than states, like Rhode Island, that embraced a more austerity-focused mindset and made deep cuts.[5] More generally, if state and local governments had not functioned as "relentless anti-stimulus machines" during the years following the Great Recession and had instead followed the approach taken with the recession of the early 1980s, recovery would have arrived four years earlier, in 2013 instead of 2017.[6] In light of this experience, cutting jobs, services, and spending would prove an irresponsible move.

It is critical that Rhode Island does not repeat the mistakes of the last downturn. The options presented here could preserve, replace, or bring in hundreds of millions of dollars in revenue, enough to cover much, if not all, of the projected shortfall, even without a new round of federal aid. We need to make investments that keep people working and spending, so that money continues to circulate in the local economy and strengthen and quicken Rhode Island's emergence from a recession and its recovery. No single method will make up for the entire revenue shortfall, but the four options discussed here could together make a huge and pivotal difference.

ENDNOTES

[1] For the revenue shortfall numbers, see the Rhode Island House Fiscal Office's May 20, 2020 Briefing on Budget Status: http://www.rilin.state.ri.us/housefiscalreport/Briefings%20and%20Presentations/2020%20Session/Budget%20Status-%20May%20%20Briefing.pdf.

[2] Erica Williams and Cortney Sanders, "3 Principles for an Antiracist, Equitable State Response to COVID-19 — and a Stronger Recovery," Center on Budget and Policy Priorities, https://www.cbpp.org/research/state-budget-and-tax/3-principles-for-an-antiracist-equitable-state-response-to-covid-19.

[3] For information on this survey, see https://www.census.gov/householdpulsedata; data here come from Week 12 of the survey: https://www.census.gov/data/tables/2020/demo/hhp/hhp12.html.

[4] These bills have been supported by the Revenue for RI coalition, of which the Economic Progress Institute is a member; see https://revenueforri.org. Revenue estimate is based on pre-COVID data.

[5] David Cooper, "Without federal aid, many state and local governments could make the same budget cuts that hampered the last economic recovery," Economic Policy Institute's Working Economics Blog, May 27, 2020, https://www.epi.org/blog/without-federal-aid-many-state-and-local-governments-could-make-the-same-budget-cuts-that-hampered-the-last-economic-recovery/.

[6] Josh Bivens, "A prolonged depression is guaranteed without significant federal aid to state and local governments," Economic Policy Institute's Working Economics Blog, May 19, 2020, https://www.epi.org/blog/a-prolonged-depression-is-guaranteed-without-significant-federal-aid-to-state-and-local-governments/.