

# Rhode Island's Fiscal Situation in a National Context

Michael Mazerov, Senior Fellow  
Center on Budget and Policy Priorities  
mazerov@cbpp.org  
Budget Rhode Map Conference,  
Sponsored by The Poverty Institute  
January 10, 2008

# You Are Not Alone!

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- RI far from alone in facing fiscal difficulties
- Budget shortfalls have opened up in several states in current 2008 fiscal year
- Budget gaps projected in 2009 fiscal year in nearly half the states; will be avoided by revenue increases and spending cuts in Governors' FY09 budgets
- Problems result from impact on revenues of slowdown in national economy

# FY08 Fiscal Situation (1)

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Ntl Conf. Of State Legislatures surveyed states in late Nov. (covering 1<sup>st</sup> 3-4 months of FY08 in most states)

Findings:

- 11 states (not incl. RI) had already revised FY09 revenue forecasts ↓; 8 more expressed “concern” about revenue outlook for rest of year

# FY08 Fiscal Situation (2)

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NCSL findings (continued):

- 9 states (incl. RI) reported revenue collections below target (esp. sales tax)
- 12 states (not incl. RI) reported spending overruns (mostly modest)
- Based on above, 7 states (not incl. RI at that point) said that FY08 budget gaps had opened

# FY08 Fiscal Situation (3)

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Some actions taken to date:

- Oct. special session in FL cut FY08 budget by \$1 billion
- 5% budget reductions ordered for some VA state agencies
- Nov. special session in MD resulted in \$1.4 billion revenue package

# FY09 Outlook (1)

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CBPP survey/paper by McNichol and Lav

- As of mid-Dec., 10 states acknowledging “budget gap” in FY09
- “Budget gap” = FY09 General Fund expenditures at current (FY08) service levels would exceed FY09 GF revenues at current tax policy
- Doesn't take account of availability or use of reserves or rainy day funds

# FY09 Outlook (2)

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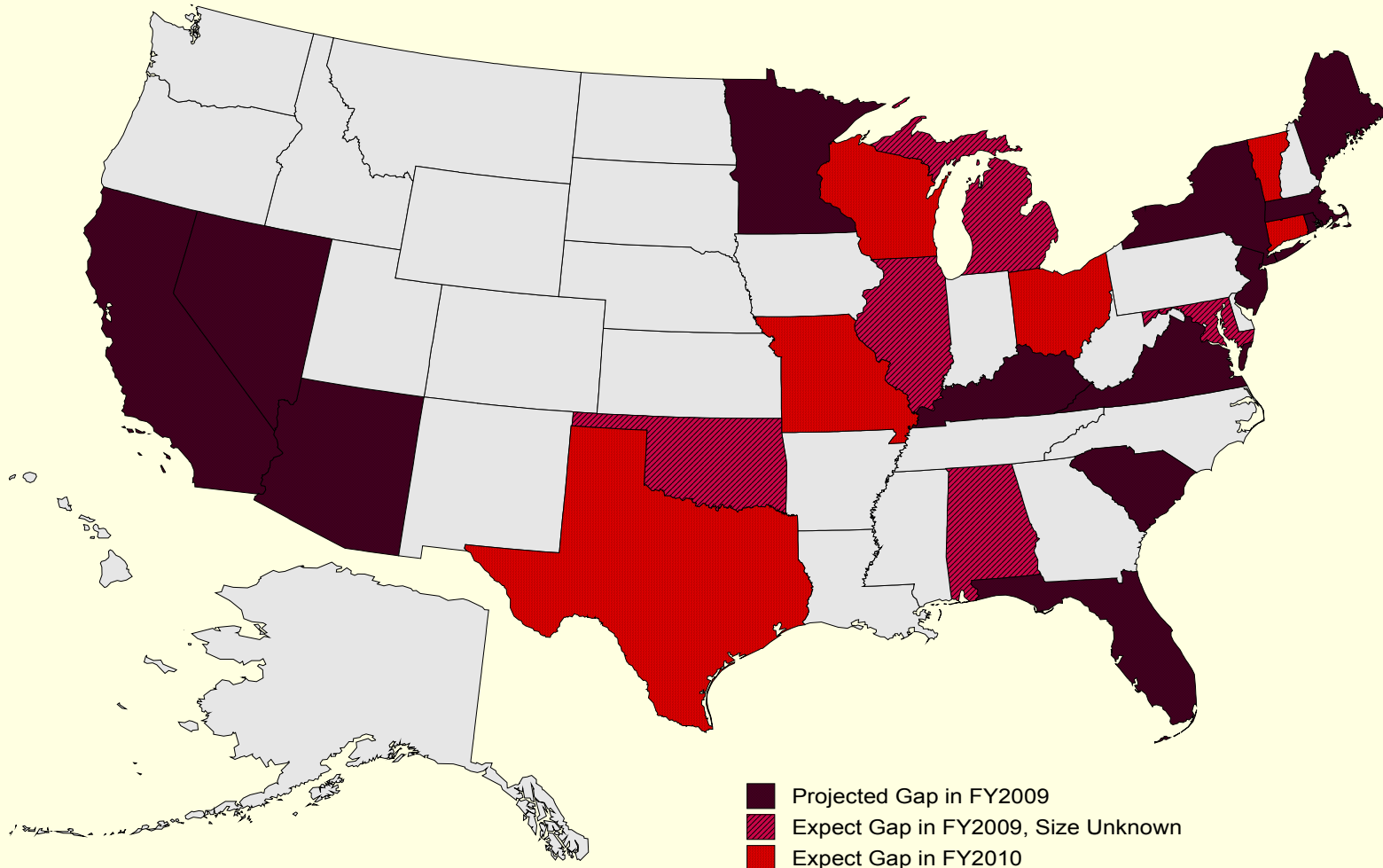
- 10 states facing “budget gap” in FY09
- 3 more states have released official FY09 revenue forecasts that show drop big enough to anticipate FY09 budget gap
- For these 13 states, gaps total \$23 b - \$30 b
- Gaps avg. 7.1% - 9.4% of states’ G.F. budgets

# FY09 Outlook (3)

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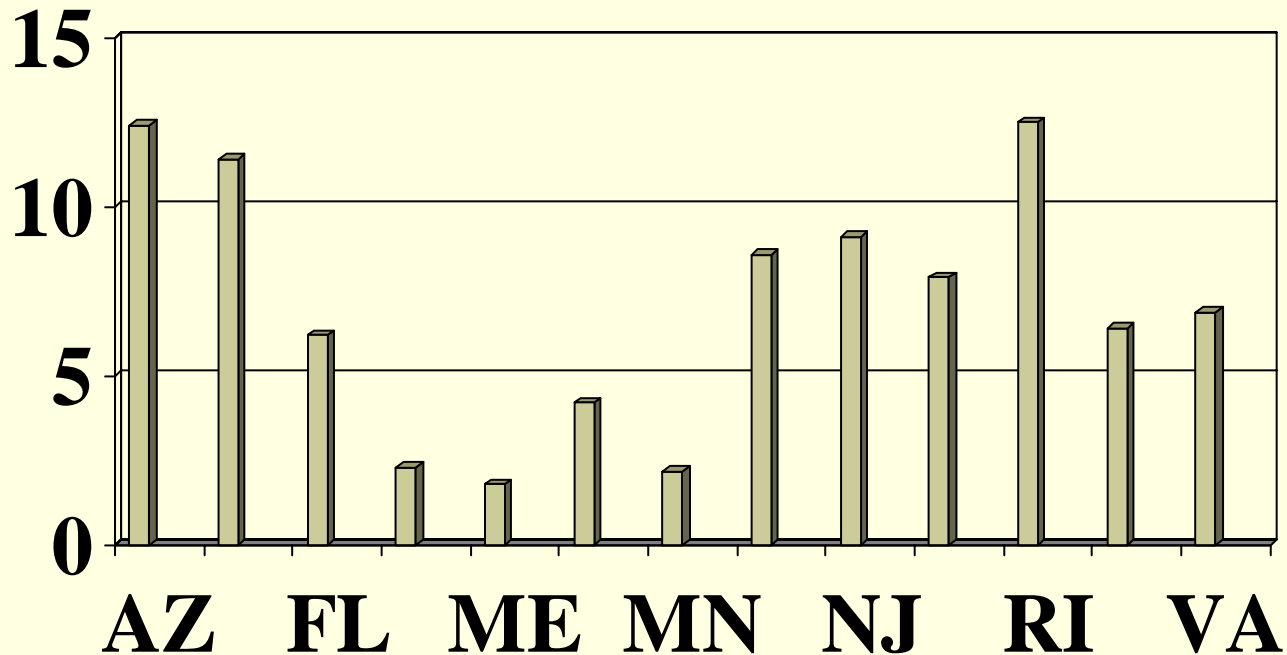
- 6 more states unofficially predict precarious FY09 budget balance with gaps of unknown size likely to open up
- 5 more states have projected gaps beyond FY09
- 24 states in all acknowledging fiscal problems

# States Projecting Fiscal Problems in FY09 and Beyond



# FY09 Outlook (4): RI's Gap May Be Largest Relative to Total Budget

Projected FY09 G.F. Budget Gaps and Revenue Shortfalls As Share of FY09 G.F. Budgets



# Past Policies Contributing to Gaps in RI and Elsewhere: Tax Cuts

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- AZ, FL, MI, NJ, VA & RI feeling effects of past tax cuts now proving unaffordable.
  - FL eliminated intangible property tax; \$150m annl.
  - AZ cut personal inc. tax rate 10%; \$335m annl.
- Back-loaded tax cuts lose more revenue over time.
  - RI phase-in of flat inc. tax for high-income taxpayers \$13m loss in FY08, \$23m loss in FY09
  - OK also with backloaded PIT cuts \$294m loss in FY08; grows to \$382m loss in FY09

# Past Policies Contributing to Gaps in RI and Elsewhere: Failure to Fix Taxes

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Failure to fix structural weaknesses in major taxes:

- Not including services in sales tax base
- Not minimizing opportunities for corp. tax avoidance
- Making personal inc. tax brackets less progressive
- Not minimizing sales tax losses from Internet sales

# States that Have Already Taken the Bull by the Horns: Maryland (1)

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- Cut rate of PIT from 5% in 1997 to 4.75% in 2002
- With other changes, 10% cut in revenue; = \$1b loss in FY08
- Combined with unfunded \$1.5b increase in aid to education
- State confronting \$1.7b budget gap in FY09

# States that Have Already Taken the Bull by the Horns: Maryland (2)

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Governor proposed package of tax increases and spending cuts and called Nov. special session.  
Outcome:

- Fully restored pre-1997 PIT top rate of 5% for taxable income between \$200k and \$350k
- Added two higher tax brackets with 5.25% and 5.5% rates
- Increased sales tax rate from 5% to 6%

# States that Have Already Taken the Bull by the Horns: Maryland (3)

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Additional changes:

- CIT rate increased from 7% to 8.25%
- Closed commercial real estate transfer tax loophole
- Expanded sales tax to include computer services (controversial; will be major push to repeal)
- Doubled cigarette tax to \$2/pack

# States that Have Already Taken the Bull by the Horns: Maryland (4)

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Overall:

- \$1.35 b tax package
- \$550m in budget cuts from current svcs levels will be needed in FY08 leg. session to balance FY09 budget
- Not a panacea; gaps will grow if referendum for slots not approved this Nov.

# States that Have Already Taken the Bull by the Horns: Maryland (4)

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Relevance to RI:

- MD policymakers just as focused on “tax competitiveness” as those in RI
- Tax package widened tax rate differentials with VA in PIT, CIT, and sales tax
- When push came to shove, policymakers agreed that preserving investments in education, health care, and other public services more important

# States that Have Already Taken the Bull by the Horns: Michigan (1)

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- In 1999, cut rate of PIT from 4.4% to 3.9% over 5yr
- With other changes, 20% cut in revenue; = \$1.6b loss in FY06
- In 1999, tax rate of “Single Business Tax” began phase-down with complete elimination later accelerated to FY08. Rate cuts and other changes reduced FY06 revenue by 34% = \$1b
- State faced \$1.4b budget gap in FY08 (beg. 10/1); \$2.6b if SBT had been allowed to expire

# States that Have Already Taken the Bull by the Horns: Michigan (2)

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Actions taken in FY08 budget:

- \$400m in spending cuts
- Increased PIT rate to 4.35%, just shy of original rate in 1999 = \$765m
- Substituted new, “MI Business Tax” — hybrid CIT/gross receipts tax — for repealed SBT.
- Enacted, then immediately repealed, broad expansion of sales tax to most services

# States that Have Already Taken the Bull by the Horns: Michigan (3)

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- For repealed sales tax on services, substituted 22% surcharge on SBT, to raise \$600m in FY08 and \$750m in FY09 (first full year)
- Substituted new, “MI Business Tax” — hybrid CIT/gross receipts tax — for repealed SBT. Included key structural reform “combined rptg”
- PIT and business tax increases enacted in state in serious economic distress, with many voices arguing for tax cuts as the solution.

# Lessons from the Last Economic Cycle

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## Tax Cuts in mid- to late-90s

- 16 states cut total taxes by at least 7%
- 28 states had smaller tax cuts
- 6 did not cut taxes at all
  
- States that cut taxes most deeply during the high-tech bubble of the late 90s experienced worse, not better, economic and fiscal impacts when the bubble burst

# Economic Track Record of 16 States with Largest Late 90s Tax Cuts

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From 2001 through 2006:

- Total employment in these 16 states grew 0.4% per year, compared to 0.9% in 34 states that cut taxes less deeply — or not at all
- Unemployment rate jumped 0.9 percentage points in these 16 states compared to 0.3 % pts in others
- Personal income grew 1.5% yearly in 16, versus 1.9% in other 34

# Fiscal Track Record of 16 States with Largest Late 90s Tax Cuts

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- 16 states with largest tax cuts had reserves at beginning of downturn = 9.5% of spending; 11.5% reserves in 34 states with smaller/no tax cuts
- Avg. FY04 budget gap of deepest tax-cutters = 13.4% of spending, compared to 8.9% for more fiscally-prudent states
- 1/2 of deepest tax-cutters had bond rating downgrades from 2001-3, compared to slightly more than 1/5 of remaining states

# Lessons from the Last Economic Cycle

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- Tax cuts don't recession-proof an economy; can make impact of an economic downturn worse
- Have your fiscal house in order before recession hits
- When you find yourself in a hole, stop digging — CT, MA, MI, OK, & OR all suspended previously-scheduled personal income tax cuts during downturn

# Tax Increases vs. Spending Cuts to Close a State Budget Gap (1)

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Brookings (now CBO) Economist Peter Orszag and Nobel Prize winner Joseph Stiglitz:

- “...tax increases on higher-income families are the least damaging mechanism for closing state fiscal deficits in the short run.”
- “Reductions in government spending on goods and services, or reductions in transfer payments to lower-income families, are likely to be more damaging to the economy in the short run...”

# Tax Increases vs. Spending Cuts to Close a State Budget Gap (2)

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Why high-income tax increases likely to be less damaging than budget cuts to state economies:

- \$1 Budget cut takes \$1 of govt. demand out of economy; \$1 tax increase takes less, because upper-income people will reduce savings to keep up consumption; reduction in consumer demand may be only \$.90
- Upper-income households have the savings and are in position to compensate in this way

# Tax Increases vs. Spending Cuts to Close a State Budget Gap (3)

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Why high-income tax increases likely to be less damaging than budget cuts to state economies:

- Larger share of consumption of high-income households that would be reduced by high-end tax increases would occur out of state (e.g. foreign travel)
- In contrast, most state govt. spending goes to local businesses: vendors (directly); merchants (spending in local stores by income transfer rec.)

# Fiscal Problems Can Create Opportunities (1)

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Even if tax rate increases may be “off the table” politically, fiscal problems create opportunities for postponed but essential structural tax reforms:

- Expanded sales taxation of services
  - States will suffer significant long-term erosion of sales taxes as consumption shifts to services if they don't start taxing them
  - Significant revenue potential in short run
  - A basic equity issue: why should people who prefer to spend their \$ on services pay less tax?
  - RI taxes fewer services than 2/3 of states

# Fiscal Problems Can Create Opportunities (2)

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- Closing corporate tax loopholes
  - States will suffer significant long-term erosion of corporate income tax if they don't minimize opportunities for large multistate corporations to shift RI-earned income out of RI
  - Targeted 2007 measures were good first step
  - Key reform is "combined reporting", treating corp. made up of parent and subsidiaries as 1 corp for tax purposes; CR in 21 states incl. NH, ME, NY
  - Gov. Patrick fighting for it in MA; if MA adopts, may be easier in RI

# Fiscal Problems Can Create Opportunities (3)

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- Chipping away at untaxed Internet/catalog sales
  - Comprehensive solution requires federal legislation
  - RI helped along by adopting Streamlined Sales Tax
  - States can chip away on their own a little bit
  - Require state vendors to charge tax on all RI sales
  - Try to force companies with in-state web “affiliates” paid by commission to charge RI tax (e.g. Amazon)
  - Try to force Internet companies with related in-state stores to charge RI tax (e.g., Sports Authority)