

Decision of the Century

General Assembly's Budget
Approach Will Set State's
Trajectory for Decades to Come

by Justin Katz and Dennis P. Sheehan

May 2020



Justin Katz

Justin Katz is the research director for the Rhode Island Center for Freedom & Prosperity as well as the managing editor of the Center's news and commentary Web site, the *Ocean State Current*.

With his eclectic interests and penchant for autodidactic do-it-yourselfism, Katz caught an early wave of blogging in 2002 with his nationally recognized site, *Dust in the Light*, which became known for its blend of philosophizing and data-driven research with a conservative perspective. In 2004, he turned his focus to Rhode Island, founding the group blog, *Anchor Rising*. He joined the Center in 2012.

As research director, Katz has become a leading analyst of the state's economy, budgets, and the legislation introduced in the Rhode Island General Assembly. His work on various subjects for the Center has ranged from development of an economic model to predict the enrollment and financial results of various school choice policies to parody songs and videos for the *Ocean State Current*.

His writing has been featured in the *Providence Journal*, *National Review*, and many other publications, including *Proud to Be Right: Voices of the Next Conservative Generation*, edited by Jonah Goldberg (Harper Collins, 2010). In 2017, the Roman Catholic Diocese of Providence presented Katz with its Lumen Gentium award for communications.

In his effort to improve governance in the Ocean State, Katz has been active in the civic life of Tiverton, where he lives with his wife and children. As a founding member of the Tiverton Taxpayers Association (TTA), Katz helped to replace the town's annual financial town meeting with a private-ballot referendum. In the past five years, he has developed and campaigned for lower-tax budgets both through individual elector petitions and as an elected member of the town's Budget Committee, winning four of those budget campaigns. In November 2018, the people of Tiverton elected him to the Town Council. As vice president of the council, he helped negotiate an innovative contract with the firefighters union that avoided arbitration, and he began public discussion of long-term planning for the town budget. Katz writes on local matters on *Tiverton Fact Check* and hosts a local podcast, *Tiverton on Track*. He is also the treasurer of TTA's charitable arm, Tiverton Cares, which provides personalized, small-scale assistance to local families in need.



Dennis P. Sheehan

Dennis Sheehan was born and raised in Newport, Rhode Island. He attended Thompson Junior High School, where his father taught, and graduated from Rogers High School. He earned a Bachelor's degree in Economics from Georgetown University in 1973 and received his Ph.D. in economics from the University of California at Berkeley in 1981.

Sheehan is Professor Emeritus at the Penn State University Smeal College of Business. He joined the faculty in 1992 as the Virginia and Louis Benzak Professor of Finance and became an emeritus professor in 2017. He previously taught in the business schools at Purdue University, the University of Chicago, and the University of Rochester.

Professor Sheehan's research and teaching interests are in finance and statistics. His research has been in corporate finance with papers on topics such as the extent and function of managerial stock ownership, the role of active shareholders in monitoring the firm, and the pricing of seasoned equity offerings by investment banks. His research has been published in journals such as the *Journal of Finance*, the *Journal of Financial Economics*, and the *Journal of Econometrics* and has also been written up in the *Wall Street Journal* and the *Journal of Applied Corporate Finance*.

At Penn State, Professor Sheehan taught at both the undergraduate and graduate levels in Finance. He has experience teaching executive development courses, having done so both in the United States and abroad for firms such as Chemical Bank, Citibank, and Xerox Corporation. In 2002, he helped start the Penn State Smeal Executive MBA program, and in 2005 he became the Associate Dean for MBA Programs; in 2009 he took on the role of Associate Dean for MBA and Executive Education. In June, 2011 he stepped down from his administrative position and returned to the Finance Department as a faculty member.

Upon retiring in 2017, Sheehan moved back home to Rhode Island to be closer to family. He lives in Middletown, where he has volunteered for the Middletown Pension Fund Committee, Meals on Wheels, and as a tax preparer in the VITA/TCE program for low-income and elderly taxpayers. He is interested in researching policies that would help improve Rhode Island's economy.

SUMMARY

A New Budget Strategy is Required in Rhode Island to Recover from the COVID-19 Crisis

In addition to the coronavirus health crisis that is affecting our lives in so many ways, the shutdown of commerce in our state is also having a crushing impact on small businesses, jobs, and family budgets — and the Rhode Island budget — creating anxiety and fears among our populace.

How lawmakers decide to deal with the almost-unthinkable projected budget gaps, caused by massive tax revenue losses, will determine the economic trajectory of our state for years, if not decades, to come. We were already experiencing an “Ocean State Exodus,” as Rhode Island suffers from one of the lowest population growth rates in the nation. Will the new budget drive more families and businesses away, or will it attract new workers and investors?

Unfortunately, all reports from Rhode Island’s executive and legislative leaders indicate that the “status quo” budget approach will prevail, an approach that seeks revenue to support existing spending programs, regardless of its effect on long-term economic growth. This approach also depends far too heavily on federal funding, with elected officials in our state hoping not to have to make the difficult budget decisions they were elected to make. Relying on federal bailouts is not a strategy!

The critical question is, What strategic path will Rhode Island’s financial recovery take? Will it go down the road of a “planned economy,” with lawmakers arbitrarily making political decisions that impose more government control over our lives? Or will the “invisible hand” of the free-enterprise system be allowed to work its magic, paving the way for more-rapid economic, jobs, and income growth?

It is not possible to accurately project how fast our state’s economy will recover and how much government revenue it may produce. Therefore, in seeking to plug what could be a \$1 billion or more deficit, a flexible budget approach is necessary, one that accounts for varying recovery scenarios and prioritizes spending to match actual realized revenue.

In these unique times, a reality-based budget strategy is required. In researching sound budgeting techniques, recommended by state policy experts and employed by many states across the country, this paper puts forth high-level budgeting guidelines that can help lawmakers navigate the uncertain and troubled budgetary waters that lie ahead.

A budget strategy that is flexible should include the following components:

- **Establishing core principles of government** to ensure that the most-vital functions of government are clearly defined as guidelines for the budget process.
- **Adopting a revenue-constrained spending philosophy** committing the state to spending only those moneys that are actually taken in, at current tax and fee rates.
- **Setting priority-based spending targets** such that specific spending categories or programs are prioritized and will be funded only as actual tax revenue is realized

In addition to these major budgeting strategies, a number of other good-government tactics should also be deployed, including new budget-cutting tools, increased budget transparency, extended periods for public and legislative debate, and the restoration of balance of power provisions.

Crafting a Budget in the Wake of the Covid-19 Crisis

High levels of anxiety about our individual and collective medical and financial security are understandably spreading across the Ocean State. Rhode Islanders are concerned about the near-term disruptions to our lives and the long-term implications.

As we look for the light at the end of the tunnel and for solutions to recover from the Coronavirus crisis, we all want our state to be a safe place to live and work. We all also want to begin recovery as soon as possible. We all want Rhode Island to emerge stronger than we were before.

One part of the solution for restoring peace of mind to our people will be reconstructing the state budget, which ultimately determines the lion’s share of our economic public policy. While combating the health crisis, political leaders also must think about the economic crisis — not just as it affects the state government, but as it affects people, their lives, and their livelihoods. These are enormous questions our elected officials are confronting.

As much as it has been a challenge, the COVID-19 crisis presents a major opportunity for legislative and other state leaders to reshape our state and etch their legacies into our state’s history for the better. Rhode Island can choose to follow the plague with a renaissance, but it will take leadership, and it will take a willingness to reimagine the way our state operates.

Decision of the Century: General Assembly's Budget Approach Will Set State's Trajectory for Decades to Come

Just like new plant growth after a major forest fire, hundreds of millions — or billions — of dollars in renewed consumer demand could be re-invested in our state to restore businesses burned by the pandemic or to build new entities from the ashes of those that did not survive. The “invisible hand” of the free-enterprise system could sweep through Rhode Island if it does not meet the anti-growth barriers historically imposed by lawmakers.¹ The critical question that state lawmakers must consider is: Will Rhode Island be seen as fertile ground for inevitable new growth ... or will investors look to other states?

In this spirit, the RI Center for Freedom & Prosperity offers constructive suggestions on how state lawmakers might better manage our state's annual budget process to provide maximum future hope and opportunity for its residents.

The Landscape as It Stands

Our state's finances are demolished. The Covid-19 crisis has not only eviscerated the incomes of families and businesses, but also decimated revenue to the government of Rhode Island. Consequently, our state is facing a devastating budget crisis and finds itself at a decision point that will determine which kind of future Ocean Staters will enjoy... or suffer.

As our state begins to plan how to restore its medical and economic health, it is impossible to predict how many companies will have survived; how quickly customers will return to entertainment venues, shops, and restaurants; how quickly employers will be able to hire back their employees; and how much overall economic commerce will be produced.

Rhode Island's general revenue will likewise be impossible to predict, meaning funding to support current spending levels is in serious doubt. The federal government is likely to continue providing aid to cover near-term medical expenses related to the COVID-19 crisis, as well as temporary aid to families and businesses, but it is doubtful that these rescue programs will substantially cover lost state revenue.

Just as all sense of normalcy in our own personal lives has been turned upside-down, creating anxiety and fear among families and employers, the assumptions that for decades have served as the foundation for our state's budget have similarly crumbled, creating problems and questions never before faced by lawmakers. They should remember, however, that every problem presents an opportunity.

¹ Christina Majaski. “Invisible Hand Definition.” *Investopedia*. May 5, 2019. www.investopedia.com/terms/i/invisiblehand.asp

The Status Quo or a New Reality?

To navigate these turbulent waters and produce positive solutions for our state, lawmakers must embrace a new and disciplined budgetary process, one that establishes clear governing principles and sets spending priorities that are flexible enough to account for at least three recovery scenarios.

To start, before lawmakers consider specific spending priorities, they must first answer the biggest question they will ever face. Fundamentally, two paths are possible, and depending on how Rhode Island plans its recovery from the devastating COVID-19 virus, the economic effects could prove to be a far more severe long-term problem than we have ever seen. Every Rhode Islander has much at stake when it comes to the question of down which path our political class will attempt to steer our budget and, therefore, our government.

Option 1: The status quo and the false budget idol. The tendency of lawmakers through years of slow economic growth and structural deficits has been to try to please as many political constituencies as possible. If that tendency continues, our representatives and senators will attempt to fully restore the state budget to the spending levels that existed before the crisis, as if those figures on a spreadsheet are sacrosanct and to be idolized.

Recent news reports signal that government officials are scrambling to find new revenue sources as a means of replacing lost tax-receipts resulting from the governor's imposed “lockdown.” Most lawmakers appear to be relying on the potential for federal bailouts. Instead of implementing sound budgeting practices, they “hope — and pray — [that] Congress bails the states out,” as the *Providence Journal* put it.²

The misguided approach of setting maintenance of the budget as the ultimate priority, regardless of any negative impacts on the populace, is 180 degrees the opposite from what it should be. For decades, our state government has done it backwards, putting preservation of the government as the sacrosanct goal, not the well-being of the people.

This path necessarily will lead to more government control over our lives and will require large tax hikes and new burdens on an already distressed private sector, which itself will be struggling to recover from the crisis. Under this scenario, it is likely that lawmakers will also seek some kind of financing scheme to kick the can down the road, which will place massive burdens on future generations.

² Katherine Gregg. “Political Scene: Lawmakers asked: How would you fix \$400M deficit?” *Providence Journal*. May 3, 2020. www.providencejournal.com/news/20200503/political-scene-lawmakers-asked-how-would-you-fix-400m-deficit

Option 2: A new reality of government living within its means. Preferably to option 1, lawmakers should come to terms with the fact that we are now living in a new reality. Gone are the reliable revenue projections; gone are the dependable employment figures; gone is budget predictability. Most of all, gone is the casual assumption that the state can live year after year on the edge of a budgetary precipice.

The alternate approach would be for the government to only spend the monies that actually come in as the economy naturally resurrects itself, without the forced confiscation of more money from the private sector in an attempt to reach some arbitrarily determined spending level. In other words, a government that lives within its means.

New York Governor Mario Cuomo echoed this approach when he proclaimed in late March that his state's budget would necessarily have to be reconstructed at a lower level, with the possibility of further "rolling budget cuts" if revenues came in at even lower levels than expected.³ Whether or not this statement accurately reflects the intentions and future of New York politics, it expresses the correct sentiment.

Rhode Island Speaker of the House Nicholas Mattiello seems to also recognize this approach, publicly stating that this is not the time to raise taxes, and several lawmakers have publicly indicated the need to keep tax rates at current levels.⁴

This second path may or may not include the tax rate cuts that our Center would recommend, but a reality-based budget must necessarily include decreased levels of spending and regulation. Rhode Island businesses and families deserve and should demand as much freedom as possible to re-engage in commerce and help grow our state's economy back to prosperity. Nobody can spot the opportunities for each Rhode Islander to innovate and prosper as well as Rhode Islanders themselves. And when they do so, they will lift the state and its government along with them.

ANALYSIS OF THE SITUATION

The Ocean State Exodus

One measure that indicates whether Rhode Island is moving in the right direction is our population. Compared with the

rest of America, the Ocean State has long ranked near the bottom for population and income growth. Every year, RI loses population to other states, maintaining its population level only with international immigration. All Rhode Islanders have stories about our children, our retired parents, and businesses fleeing our state to live and work in other states where resources and productive energy can go further.

Mike Stenhouse, CEO RI Center for Freedom & Prosperity

There is no time for the status quo approach. The post-virus approach for our state must put us on a new path — a path that puts the Rhode Island people first! State lawmakers must focus all energy on broadly rebuilding the private sector economy, along with its related jobs and commerce.

There is no time for the same old budget approach that has created the worst business climate in the nation. There is no time to falsely worship budget-figures on a piece of paper. There is no time for the rest of us to continue to sacrifice to meet the state's voracious spending appetite. There is no time to continue the status quo handouts to insider cronies. There is no time to raid or "scoop" from non-general fund accounts. There is no more time for lawmakers to keep kicking the can down the road and avoiding making the difficult decisions that they were elected to make.

There is no time for the political class to continue to serve as enablers for ineffective agencies and programs by automatically adjusting budgets for inflation and caseload increases, with a focus on inputs rather than outcomes. In short, there is no time for the insider, arbitrary, and politically driven decision-making process that has dominated our state for decades.

³ John Cropley. "Cuomo proposes rolling budget cuts to absorb impact of COVID-19." *The Daily Gazette*. March 26, 2020. [dailygazette.com/article/2020/03/26/cuomo-proposes-rolling-budget-cuts-to-absorb-impact-of-covid-19](https://www.dailygazette.com/article/2020/03/26/cuomo-proposes-rolling-budget-cuts-to-absorb-impact-of-covid-19)

⁴ See footnote 2.

Decision of the Century: General Assembly's Budget Approach Will Set State's Trajectory for Decades to Come

Quite simply, Rhode Island is becoming a less popular destination where people choose to raise their families or build their careers. That is why the *Wall Street Journal* projects RI will lose one of its two prized U.S. Congressional House seats following completion of the 2020 national census.⁵

Since before it was the RI Center for Freedom & Prosperity, our organization has been warning about the consequences of this trend. In 2017, for example, we noted that the number of Rhode Islanders leaving for other states — and not replaced by Americans moving in the other direction — was roughly equivalent to the population of 11 of our towns (see Figure below).

The old adage is true: People vote with their feet. For Rhode Island, the exodus of productive people walking away from our state — along with their incomes, wealth, and charity — is, sadly, a statistical manifestation of those many anecdotes.

Again, Rhode Island faces a choice. Our state can return to business as usual, driving productive Rhode Islanders to other states that will allow them to recover and advance more readily. Or our state can redefine itself and reverse the tide of domestic migration.

This choice will be made as our legislators decide how to craft the budgets over the next few years. More than any single other factor, the budget will determine whether the Ocean State Exodus continues or reverses.

⁵ Danny Dougherty. "These States Are on the Cusp of Losing Power in the House." *Wall Street Journal*. December 20, 2018. www.wsj.com/graphics/reapportionment-2018/

Stress-Testing Rhode Island's Budget: Potential \$1 Billion Budget Shortfall

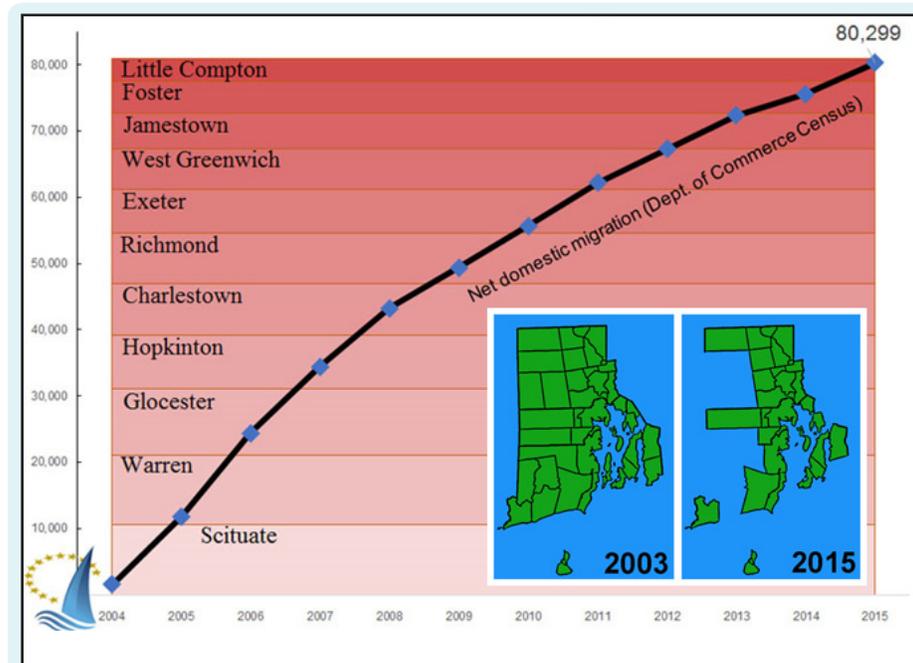
Rhode Island will be facing an unprecedented budget crisis. Although the data are uncertain, the crisis will likely be larger than the Great Recession of 2008, when general revenue was 10% below the forecast budget. According to the Urban Institute, RI's own-source revenue fell from \$6.3 billion in 2007 to \$2.5 billion in 2009, a decrease of roughly 60%.⁶

The FY20 budget ending this coming June 30 may be even more drastically affected. At the same time revenue is falling, the state faces increased demand for spending through programs such as Medicaid and unemployment assistance. The governor and General Assembly have already begun to revise the budget in light of the pandemic, and these revisions will be on a scale with which we have little to no experience.

The Federal Reserve Bank of Boston estimated that RI could face a one-year shortfall of up to \$460 million, a deficit that could grow larger if our state's forced economic shutdown lingers much longer — or returns.⁷ One factor driving these

⁶ Urban Institute. "State and Local Revenues." <https://www.urban.org/policy-centers/cross-center-initiatives/state-and-local-finance-initiative/state-and-local-backgrounders/state-and-local-revenues>

⁷ Larry Bean. "New Boston Fed analyses outline grim economic consequences of COVID-19 pandemic in New England." Federal Reserve Bank of Boston. April 22, 2020. www.bostonfed.org/news-and-events/news/2020/04/neppc-covid-analysis.aspx



Eleven Towns' Worth of Rhode Islanders Leaving the State, 2004-2015

Source: U.S. Department of Commerce Census.

losses is unemployment insurance claims, for which the Ocean State ranks dead last, with the highest number of claims as a share of the labor force.⁸

Similarly, Moody's Analytics does "stress testing" of every state's budgets in order to give states information about how to cope with an economic downturn. In its most recent pre-crisis stress test of October 2019, the organization predicted that, during a severe recession, Rhode Island would suffer a 12% fiscal shortfall from reduced tax revenue and increased Medicaid spending, which translates into a \$500 million budget shortfall. This massive budget gap would be on top of the hundreds of millions in structural deficits already inherent in the state's budget.

Moody's "stress test" did not account for the calamity we now face because of the COVID-19 pandemic, so it is reasonable to project that the budget shortfall could be 20–30% higher. Adding up the structural deficits and the crisis stress-test deficits, it is conceivable that the Ocean State's budget problem could approach, or even exceed, \$1 billion over two fiscal years.

RI lawmakers failed to build up sufficient reserves during the recent decade-long economic expansion. In part, this resulted from the state economy's structural inability to capitalize on the expansion (never reaching, for example, its full pre-recession employment level). More directly, the state merely spent increasing revenue, often on special-interest causes.

Moody's rates Rhode Island as being among the states that are least prepared for a severe recession because the state's "rainy day" funds amount to only about 5% of the budgetary shortfall, leaving at least a 7% deficit in the generic recession that the firm analyzed.

It is clear from these figures that the entire RI budget will need to be rethought with an entirely new approach.

Recession and Recovery

The FY20 and FY21 budgets depend on both the magnitude of the recession and the speed of the recovery. The decline in economic activity will reduce the tax revenue coming into government. In the FY21 budget that the governor proposed before the pandemic hit, about two-thirds of tax revenue comes from personal income taxes and sales and use taxes, both of which will suffer large declines. One measure

of RI's decline is unemployment compensation. More than 20% of the labor force has applied for this benefit.

In the Great Recession of 2008–2009, real gross domestic product (GDP) contracted about 4–5% on an annualized basis, and state GDP 2–3%. This resulted in a state budget shortfall (forecast minus actual) of 10% in 2009 and 4% in 2010. Although there is great uncertainty about the economy in 2020, the predicted declines in economic activity nationally in 2020 range from about -4% to -10%:

- Conference Board:⁹ -4% to -7%
- Wall Street Journal Survey of economists:¹⁰ -5%
- Goldman Sachs:¹¹ -6%
- Morgan Stanley:¹² -6%
- Deloitte:¹³ -8%
- Nomura Securities:¹⁴ -9%
- Federal Reserve NY:¹⁵ -9%

Several of these forecasts were done in late March or early April, when it was possible to be more sanguine about our economic condition. Subsequent reports, such as unemployment filings, have produced much more sobering news.

These forecasts are for the 2020 calendar year, and they assume some recovery in the third and fourth quarters. The state's 2020 fiscal year ends on June 30 and will therefore only reflect the enormous decline in economic activity in March through June. Even optimistically, Rhode Island

⁹ The Conference Board. "The Conference Board Economic Forecast for the US Economy." www.conference-board.org/publications/Economic-Forecast-US

¹⁰ *Wall Street Journal*. "Economic Forecasting Survey."

¹¹ Jeff Cox. "Goldman sees 15% jobless rate and 34% GDP decline, followed by the fastest recovery in history." CNBC. March 31, 2020. www.cnbc.com/2020/03/31/coronavirus-update-goldman-sees-15percent-jobless-rate-followed-by-record-rebound.html

¹² Steve Goldstein. "Morgan Stanley releases new forecast showing U.S. economy may drop as much as 38%." *MarketWatch*. April 3, 2020. www.marketwatch.com/story/morgan-stanley-releases-new-forecast-showing-us-economy-may-drop-as-much-as-38-2020-04-03

¹³ Daniel Bachman. "United States Economic Forecast." *Deloitte Insights*. March 27, 2020. www2.deloitte.com/us/en/insights/economy/us-economic-forecast/united-states-outlook-analysis.html

¹⁴ Lazard Asset Management. "Outlook on the United States." April 2020. www.lazardassetmanagement.com/research-insights/outlooks/united-states

¹⁵ Daniel Lews, Karel Mertens, and James Stock. "U.S. Economic Activity during the Early Weeks of the SARS-Cov-2 Outbreak." SSRN. April 14, 2020. papers.ssrn.com/sol3/papers.cfm?abstract_id=3574732

⁸ Edward Fitzpatrick. "Rhode Island has the highest rate of unemployment claims in the country." *Boston Globe*. April 10, 2020. <http://www.bostonglobe.com/2020/04/10/metro/update-coming-1-pm-covid-19-rhode-island/>

Decision of the Century: General Assembly's Budget Approach Will Set State's Trajectory for Decades to Come

should be preparing for at least a 5–10% decline in revenue and, more likely, a revenue decline that is two or three times that. Indeed, in a *Providence Journal* article on April 26, the Department of Administration director is reported as saying that Moody's estimate of \$630 million in revenue losses over this year and next may be a "significant underestimate."¹⁶

A V-Shaped Recovery?

The economy should begin to recover in 2020 as restrictions are relaxed, but the recovery path is even more uncertain than the decline. We can hope that a quick rise in economic activity will follow the current plunge. With a V-shaped recession pattern, economic growth might only be negative in the first two quarters of 2020, followed by a large rebound as people return to work, shopping, and other activities. This would be similar to the brief recession experienced in 1990–1991. In a case like that, the FY20 budget would be affected, but there would be hope that the FY21 budget would not be as harmed. In this scenario, the FY20 general revenue might suffer a decline of 10–20%, roughly \$400 million to \$900 million; the FY21 budget would not be as affected, perhaps only by 3–5%.

Given what we know as of the end of May, including a slow and tentative reopening plan from the governor, a V-shaped decline and recovery seems very unlikely. The massive increase in economic uncertainty is unprecedented and is likely to lead to a slower recovery. Both consumers and businesses will be cautious about spending and investing. This will significantly reduce economic activity for the next year or two, as people will be reluctant to start new businesses or invest in their current businesses. Employment growth will stall because of fears that economic growth will be weak or nonexistent.

Or a U-Shaped Recovery?

Even if restrictions are lifted in May, the tremendous uncertainties about infection and treatment will mean that many people will continue to self-isolate. In this case, the recovery would be more U-shaped, similar to the sharp plunge and slow recovery of the Great Recession. In this case, we are likely to see negative economic growth for several quarters, followed by positive economic growth sometime in 2021. But that growth may be anemic enough to prevent a full

recovery before 2022 or beyond. After all, when COVID-19 hit the Ocean State, Rhode Island had *still* not fully regained all of the employment it had lost in the Great Recession.

In this scenario, the FY20 budget would be dramatically affected, as both the third and fourth quarters of the fiscal year have been hammered by the shutdown, with virtually no recovery. The FY21 budget would also be hit hard, with little to no growth from the FY20 decline. As an estimate, the FY20 general revenue would decline by \$400 million to \$900 million, but then the FY21 general revenue might recover only a fraction of that decline.

Hopefully Not an L-Shaped Recovery!

Other economic recovery scenarios are, sadly, even worse. Similar to the Great Depression, an L-shaped recovery means there is no recovery for an extended period of time. The economy sputters along without growing at any significant pace for several years. Needless to say, this outcome would be a disaster for Rhode Islanders, as living standards will be reduced for a decade. The results will be even worse if other states perform better and recover more quickly and Rhode Island's most productive residents decide to go elsewhere to put their labor and capital to productive use.

As we plot a path forward, lawmakers must realize that we can influence the speed of the economic recovery by encouraging economic activity. We should work to ensure that the obstacles to increasing economic activity and growth are as small as possible. Thus, even as our political leaders should plan and prepare for the worst outcome, they should also take steps to ensure that it never becomes more than a planning scenario on a piece of paper.

SOLUTIONS

Whatever one believes about the strategy of locking down for months to stop the spread of COVID-19, it is obvious that the consequences for the economy and states' budgets will be enormous. Ideas for solving that second-wave crisis are already making their way through the public square.

Federal Bailout Funding

Based on reported comments by public officials, it appears that the dominant hope to repair our state budget will be a potential "free" federal bailout. Federal bailouts are not free, as every federal taxpayer will face an increased tax burden. Furthermore, such bailouts often come with mandates and "strings" attached that decrease state sovereignty and

¹⁶ Katherine Gregg. "Governor urges patience amid State House protest." *Providence Journal*. April 25, 2020. www.providencejournal.com/news/20200425/governor-urges-patience-amid-state-house-protest

require states to invest their own funds in future years to maintain the mandated programs.

A secondary effect of federal bailout is that limits on how the money is used tends to generate incentives for creative accounting at the state level to fit all prior spending into the required box. This distorts the budgeting process, reduces transparency, and increases the possibility of abuse. Even where programs are not *required* to continue beyond the duration of the bailout, the period of misleading accounting creates expectations and habits that affect budgeting practices indefinitely.

Bailout funds can often be thought of as extra money, which can be irresistible for lawmakers to earmark for favorite pet projects or other frivolous programs that could not otherwise find funding. Instead of allocating the federal aid to plug actual budget gaps that can be attributed to the coronavirus pandemic or to provide relief that will encourage economic growth, state budgeters rationalize unnecessary additional spending.

For all of these reasons and more, federal bailouts are a dangerous precedent to set. States are well-equipped to handle these challenges for themselves — or the electorate should demand that they become so. Bailouts thus become enablers of bad fiscal and civic habits.

At least for a first pass, the decision has already been made by Washington. Federal bailout money has arrived, courtesy of the CARES Act. Nonetheless, the RI Center for Freedom & Prosperity recommends that Rhode Island plan that

any such bailout funds should be invested in an additional boost of near-term economic growth. In combination with spending reductions, a temporary lowering of individual and business taxes that might otherwise slow our state’s economic recovery would have the most beneficial long-term benefits for our state and for the budget.

Leaning on Debt

One possible strategy for dealing with the state’s looming difficulty collecting revenue is arguably more of an exaggeration of a long-running practice: increased debt. On this subject, policymakers must recognize that Rhode Island’s debt burden on taxpayers is already significant. As the chart below shows, the per capita debt burden on taxpayers in Rhode Island is consistently about 2.5 times the burden of the average state in the United States.

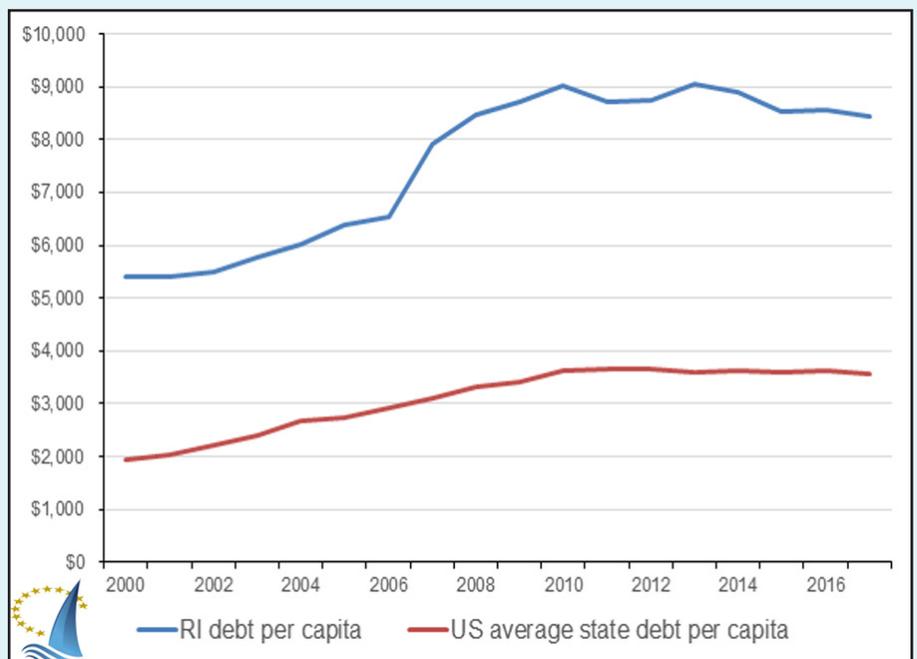
According to the most recent Debt Affordability Study of July 2019 conducted by the State Treasurer’s Office, the state has multiple sources of indebtedness (see table on next page).

This \$13 billion in debt is roughly \$13,000 for every single resident of Rhode Island. (That’s \$52,000 for a family of four.) On top of this mountain, local municipalities and special districts have around another \$9 billion in liabilities, 90% of which is unfunded pension liabilities.

It should be evident to everyone that Rhode Island’s true indebtedness has risen dramatically because of the pandemic-imposed economic crisis. Public pensions were significantly underfunded before the crisis, and they are now in even

Rhode Island and U.S. Average Debt per Capita

Source: Urban Institute. “State and Local Finance Data.” state-local-finance-data.taxpolicycenter.org/pages.cfm



Decision of the Century: General Assembly's Budget Approach Will Set State's Trajectory for Decades to Come

worse shape, because of the decline in the stock market and the fall in interest rates. In April of this year, it was reported that Rhode Island's state pension investments suffered a 10% loss in the first quarter of 2020, or almost \$1 billion.

RI State Government Indebtedness (\$M)

	State	Quasi-public agencies
General obligation and leases	1,862	6,875
Unfunded pension liabilities	3,380	21
Other post-employment benefit liabilities	616	12
Total	5,858	6,908

Source: Rhode Island and Providence Plantations Public Finance Management Board. *Debt Affordability Study*. July 25, 2019. d10k7k7mywg42z.cloudfront.net/assets/5d499bc521c79b17047b89e9/2019_DAS.pdf

The unfunded pension liabilities are significantly understated because state and local governments use high rates, generally around 7%, to value their future liabilities. A more-correct rate to use when valuing the liabilities would approximate the state's borrowing rate, which would cause pension fund liabilities to more than double. So, a more-realistic measure of the state indebtedness is \$16–18 billion. And if we measure the local pension fund liabilities more correctly, they would be \$17–18 billion. Thus, the total for the whole state is roughly \$30–40 billion.

The ratings agencies use various financial ratios when rating a state's debt. One is the amount of debt to the gross state product (GSP). In the Debt Affordability Study, the debt to GSP is estimated to be about 3%, a figure which sounds quite reasonable. But that figure takes only the roughly \$2 billion of tax-supported debt as its numerator. Even using the — understated — total debt from that study, a more-correct ratio is total state debt as a ratio to GSP, which produces a figure of 21%. Obviously, if we were to include local debt, that would raise the ratio even higher, to 35%. Valuing pension-fund liabilities correctly would increase the ratio to more than 50%.

One reason for historical growth in public debt is that it is an easy solution, providing benefits in the moment, with the costs imposed in the future. Often those costs won't be experienced until the people incurring the debt have moved on.

During this crisis, the state has only made this problem worse. In March, Rhode Island borrowed \$150 million to

help manage its budget, which of course created added debt burdens. More borrowing is almost certain, now that state officials have discovered that an emergency allows them to shorten the process of increasing debt, far removed from a need for direct public approval.

Relatively recent requirements for state and local governments to acknowledge long-term liabilities like pensions should have taught us the lesson that debt inexorably consumes ever-larger portions of a budget. Moreover, businesses, residents, and other people investing in a state in one way or another will adjust their expectations and redirect their efforts elsewhere if they sense that a region's government is not addressing problems, but merely looking to postpone a reckoning. This creates a spiral; as the financial clouds darken, more people seek to withdraw from the field, and the burden increases proportionally on those who remain... which increases the need to fill gaps with debt.

At our current point, the combined impact of increased liabilities plus significantly reduced revenue receipts from the shutdown of the state's economy may be too significant to handle for lawmakers who refuse to make politically perilous spending cuts. It is not out of the question that Rhode Island could end up defaulting on its obligations. If so, it would not be unreasonable to ask that current or future public employee union employees and retirees, as well as state bondholders, share some of the burden in reducing cost pressures on the state budget.

The Time is Now for Revenue-Constrained, Priority-Based Budgeting

Never has there been a more-important time for the Ocean State to modernize its budgeting system. The RI Center for Freedom & Prosperity recommends a process that budgets based on defensible priorities while acknowledging and adjusting to the actual level of revenue that the state receives.

The devastating economic impact of the COVID-19 shutdown requires Rhode Island's 2021 state budget to be reconstructed at a significantly lower level, and lawmakers should utilize a clear and transparent method to determine how much revenue to plan for, which spending programs are essential, and which taxes and regulations should be modified. A new budget discipline should provide a framework to answer these and the many other questions that will arise as state officials seek solutions to the budget's massive new shortfalls. Once established, such a framework will help Rhode Island to eliminate structural deficits and pave the way for rapid and long-term economic recovery.

Like purifying water, our budget requires multiple layers of refinement. Think of them as separate filters that only let the necessary, healthful budget priorities through:

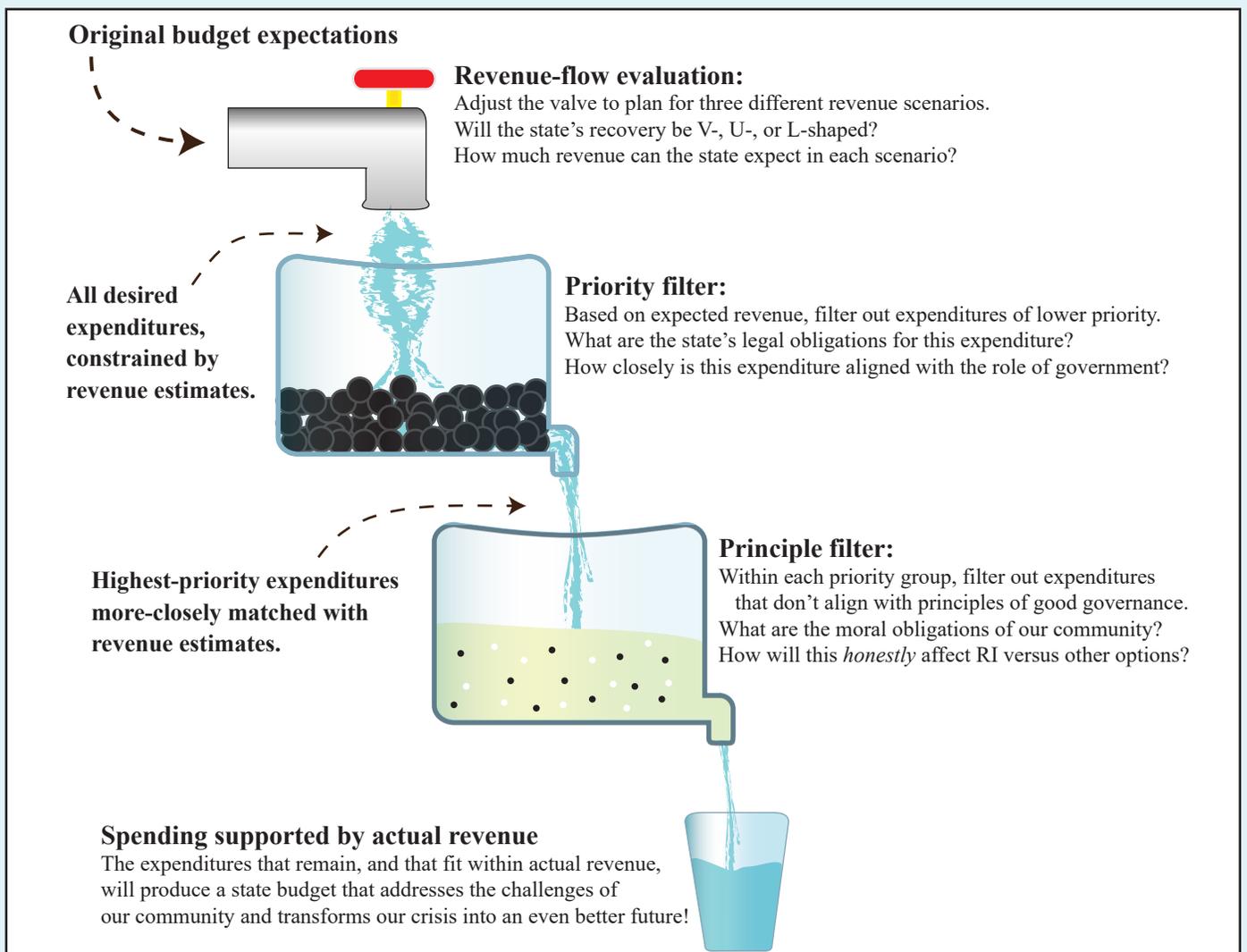
1. **Revenue-flow evaluation.** Forecast multiple revenue scenarios based on V-, U-, and L-shaped recoveries so that decisions about spending priorities can be made deliberately and before revenue realities make them pressing.
2. **Priority filter.** Define the level of priority that each expenditure should have, whether based on the amount of legal obligation it imposes or the degree to which it is clearly and uniquely the role of government.
3. **Principle filter.** Clearly articulate core governing principles that guide all budget decisions, honestly assessing the social and economic effects of each.

Revenue-Flow Evaluation

As part of its budgeting process, Rhode Island twice a year conducts a revenue conference at which experts attempt to predict the course of the state's economy and its effect on likely revenue for the government. The most recent Conference reported on May 9, 2020 that the state faces a \$800 million general revenue shortfall over the budget years 2020 and 2021; they predicted that the FY20 tax collections would decrease by \$280 million from the previous forecast, and that FY 2021 tax collections would decrease by \$520 million.

The Conference is forecasting a 15–20% reduction in tax revenue in the FY20 budget. For the 2021 budget, it appears they are forecasting a roughly linear increase in economic activity from the second quarter, April–June 2020.

Revenue-Constrained, Priority-Based Budgeting



Decision of the Century: General Assembly's Budget Approach Will Set State's Trajectory for Decades to Come

Estimated Revenue Scenarios for Rhode Island State Budgeting

	V-Shaped Recovery	U-Shaped Recovery	L-Shaped Recovery
FY20	-5% to -15%	-5% to -15%	-10% to -20%
	-\$200 to -\$600 million	-\$200 to -\$600 million	-\$400 to -\$800 million
FY21	-3% to -5%	-7% to -12%	-10% to -20%
	-\$100 to -\$200 million	-\$300 to -\$500 million	-\$400 to -\$800 million
Total	-4% to -10%	-6% to -14%	-10% to -20%
	-\$300 to -\$800 million	-\$500 to -\$1.1 billion	-\$800 to -\$1.6 billion

Thus the reduction in tax collections might be approximately 20% in the first quarter of the budget (July to September), but then be only 5% in the fourth quarter of the 2021 budget.

Given enormous uncertainty about the recovery, the Revenue Estimating Conference will need to construct several scenarios, especially for the 2021 budget. In particular, there should be a plan for a very slow recovery. The state has to plan for the highly pessimistic outcomes while hoping for more optimistic ones. A V-shaped recovery is highly optimistic; an L-shaped recovery is highly pessimistic but, unfortunately, possibly more realistic. We believe the state should be prepared for a very slow recovery that could take years. As an example of shortfalls in tax revenues under different scenarios, the table on this page summarizes our estimates.

Priority Filter

The first step in evaluating any listed budget is to understand what choices you actually have. Some expenditures may produce very little benefit, but they are legal obligations, and cuts are therefore off the table. Like any family that has to cope with higher local tax bills, alimony paid to a former spouse, or debt that a teenager managed to rack up on a parent's credit card, some bills must be paid. Our state government has certain inescapable obligations.

On the other end of the spectrum would be expenditures that ought to be halted even if you have the money for them. In everyday life, examples might be paying late fees on bills that you have the money to pay, subscriptions to services that you don't even remember how to access, or restaurant tabs that an in-law has been somehow managing to get you to pay.

In terms of the state budget, we suggest establishing a hierarchy of state expenditures from "must do" to "shouldn't do." For example:

1. **Legal obligations.** These include any expenditures that the state would be forced to pay, even if it refused to budget for them (e.g., state debt).
2. **The most central activities of government.** These are the activities that are at the core of our reason for establishing government in the first place (e.g., public safety and infrastructure).
3. **Activities from which we cannot easily extricate the state.** Included in this category would be any expenditures that are bound up in so many legal complications that it would be counterproductive to try to end them. For some expenditures, the political difficulty of large reductions would be such that overreach could undermine the entire budget plan. Also included would be government activities on which large portions of the public have based major life decisions, so that it would be unjust to undermine their plans (e.g., public education and entitlement programs).
4. **The nice-to-have.** These would be line items representing things that might be reasonably done through government, but that are the luxuries of a prosperous time and well-run state (e.g., public events, community grants, and open space).
5. **Activities that could be privatized or that aren't truly the role of government** (e.g., corporate welfare and legislative grants)
6. **Outright waste, fraud, and abuse.** The existence of this type of spending is denied almost as often as it is cited as a source of revenue for new policies. However, the crucible of an economic calamity should make examples easier to see.

Each of the revenue-flow scenarios described above will produce a point at which revenue will run out compared with original budget expectations. Hopefully no scenario will place that point before priority 4, so that reductions, though difficult, will not be politically unmanageable.

Having put all expenditures into its appropriate group, budgeters can determine, beforehand, which expenditures have no chance of being funded, which will be the first to go if the economy struggles, and which can proceed under the assumption that they're safe.

Principles Filter

The final step for preparing alternate budgets is mainly about differentiating between expenditures in the same category of priority. If the state can only fund a half of all requested expenditures that are “nice to have,” how does it determine which half? Note, of course, that the lines between the filters don't have to be strictly sequential. Something that is only “nice to have” might be so valued in principle that the state is willing to take additional steps to extricate itself from something in category 3.

The Center offers the following list of priorities for consideration. In compiling it, we juxtapose items against each other to emphasize the need to consider tradeoffs. From our point of view, we have attempted to combine the proven and common-sense principles of the free-enterprise system along with principles of a fair and just social welfare system. It is motivated by a belief that, although the government can help in many areas, it is not the sole or even the most important actor in creating civil society.

- **Business environment.** Does this expenditure provide broad and equal support for all businesses and improve our state's last-place-ranked business environment, or does it limit access and constrain the long-term economic opportunity for all businesses, families, and individuals?
- **Education.** Does this policy enhance student opportunities, or does it give too much weight to legacy habits and reduce the opportunity for student achievement?
- **Healthcare.** Does this approach create more options for people to improve their personal health and safety, or does it attempt to insulate the investments of entrenched players in our healthcare system?
- **Infrastructure.** Does this strategy give a limited number of providers a secure and reliable source of revenue on which to base large investments, or does it make it more difficult for the state to improve and maintain the infrastructure that facilitates statewide mobility of people, goods, information, and energy?
- **Welfare.** Does this spending provide a safety net for Rhode Island's most vulnerable populations, or does it discourage productive activity?

*Don't miss any opportunities!
 As the revenue estimating conference
 evaluates the effects of our recession,
 it will generate valuable information
 about how the recession can be
 softened through various forms of
 tax and regulatory relief.*

- **Labor.** Does this assistance ensure that those who have invested in Rhode Island's historical workforce needs will continue to have a place in our economy, or does it protect narrow special interests, cartels, and established insiders at the expense of others' ability to adapt and flourish?
- **Land use.** Does this investment maintain the beauty, cleanliness, and public access of Rhode Island's natural resources, or does it create NIMBY barriers and lock-up natural resources?
- **Open government.** Does this rule enhance government transparency and citizen access to government and preserve property, religious, and other constitutional rights, or does it shield insiders from accountability?

We believe that time spent in public debate on these matters would not be wasted, even if it were never applied to an actual budget decision. The State of Washington actually put together a special commission to consider such principles and make recommendations on “principles of governing” that were formally adopted. However, the reality is that some list of principles is being applied, whether it's acknowledged or not — whether the decision-makers are aware of it or not. Given our new reality, the Ocean State can no longer afford to operate that way.

Other Budget Recommendations

As Rhode Island plans its economic and budgetary recovery from the pandemic, and regardless of whether or not state lawmakers adopt a new approach when rethinking the budget, it is vital that a high-degree of flexibility be embedded in the process, along with as many cost-savings tools and

Decision of the Century: General Assembly's Budget Approach Will Set State's Trajectory for Decades to Come

ideas as possible. We here provide a non-exhaustive list of recommendations that can help toward that end.

- **Increase budget transparency.** Make the budget revision process open and transparent. We face an unprecedented crisis. There should be an attempt to solicit and consider many opinions about how the budget should be changed. Let's have a debate about how our spending needs to change.
- **Avoid budget gimmicks like "scooping."** This is a time for honesty with the people of Rhode Island ... not for tricks.
- **Extend the period before a floor vote.** This year, especially, when there is so much budget uncertainty and when the approach taken by legislative leaders will have such a profound effect on public policy for years to come, rank and file lawmakers must be afforded extended opportunity to examine and evaluate the budget. This is not the time to rush things through.
- **Restore balance of power spending provision.** Until 2018, the governor had the power to unilaterally reduce or suspend state expenditures if the state budget officer determined that revenue would not meet the projections. She could not reduce certain categories, such as the General Assembly's budget, and she was required to give 10 days' notice to the speaker of the house, senate majority leader, as well as the chairpersons of the house and senate finance committees. This power would have been tremendously useful in the current crisis. Unfortunately, in 1997, the General Assembly repealed Title 35, Section 3-16, which had granted that power to the governor.
- **Implement a line-item reduction veto (LIRV).** This is a more-flexible version of the traditional line-item veto tool, giving the governor authority to eliminate or reduce wasteful or unnecessary spending, without vetoing the entire budget. It could be paired with an ability to reallocate funds that were not spent because certain government services were ended or suspended due to the pandemic.
- **Freeze hiring.** Taking new hiring off the table, including the decision not to replace retiring or departing workers, would help lawmakers and executive agencies focus on efficiency and placing resources (including human resources) where they are most needed.

SPOTLIGHT ON SPENDING

In 2014, in cooperation with the Taxpayers Protection Alliance, the RI Center for Freedom & Prosperity reviewed the state's budget, finding almost \$225 million in non-essential spending.¹⁷

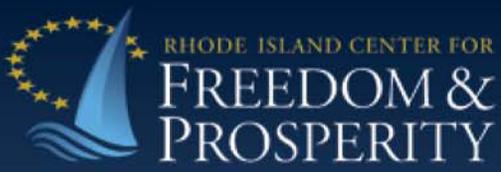
That report no longer applies directly to more-recent budgets. The amounts of line items will have changed, and the General Assembly already followed through on some of the suggestions contained therein. In other cases, new government structures have become sufficiently established that our recommendations are no longer feasible. (Our 2014 proposal to eliminate the Office of Management and Budget would be a good example.)

Nonetheless, we refer readers to the *Spotlight on Spending* report for examples of line items and the reasoning we apply when making such recommendations. For the purposes of this brief, we reproduce the summary table from this earlier report.

¹⁷ Drew Johnson and Justin Katz. *Spotlight on Spending*. RI Center for Freedom & Prosperity. April 2014. rifreedom.org/wp-content/uploads/ricfp-spotlightonspending-fy15.pdf

Opportunities for Budget Saving's from the Governor's Proposed FY15 Budget

	Recommendation	Suggested Savings (\$M)
Handouts		
House and Senate Legislative Grants	Eliminate	2.3
Community Service Legislative Grants	Eliminate	8.7
Governor's Workforce Board	Eliminate	8.4
Workforce Training Grants	Eliminate new	0.5
State Council on the Arts	Eliminate general fund	2.3
Film & Television Office	Eliminate	0.3
Motion Picture Tax Credits	Eliminate	3.1
Blind Vending Services Program	Eliminate	0.2
Historical Preservation and Heritage Commission	Eliminate general fund	1.0
New Historic Tax Credits (maximum)	Eliminate new cap	50.0
Higher Education Capital Budget	Halt Inn project	2.2
Library Aid for Wealthy Communities	Reduce by 25%	2.2
Other Government Handouts	Eliminate	34.9
Absorptions		
Office of Management and Budget	Eliminate	2.0
Other Absorptions	Eliminate	30.2
Operations		
Facilities Management	Freeze budget	2.8
Licensing and Regulation	Reduce budget 25%	2.3
Convention Center Authority	Freeze budget	2.7
Corrections Inmate-Related Expenses	Hold to inmate increase	0.5
Commission on Disabilities	Return to FY13	1.0
New Voting Booths	Eliminate	0.1
Health and Human Services Central Management	Freeze operations	1.3
Commerce Corporation (EDC)	Freeze operations	0.4
Supplies and Expenses Increases	Freeze	11.3
Personnel		
Governor's Office	Reduce payroll 15%	0.6
General Assembly	Reduce payroll 15%	4.9
Lieutenant Governor's Office	Reduce to 1 assistant	0.8
Legislative Grant Coordinator	Eliminate	0.1
Atomic Energy Commission	Reduce payroll 50%	0.5
Goddard State Park Golf Course Supervisor	Eliminate	0.1
Ethics Commission	Reduce payroll 50%	0.7
Office of Diversity, Equity and Opportunity	Consolidate	1.2
Creative and Cultural Economy Coordinator	Eliminate	0.1
Certificate of Good Conduct Program	Eliminate new funds	0.1
Office of Community and Family Health & Equity	Reduce payroll 15%	2.6
Overtime expenses	Reduce	19.1
Overreach		
Unified Health Infrastructure Program (UHIP)	Eliminate	15.2
Full-day-kindergarten pilot program	Eliminate	1.7
Commerce Corp. (EDC)	Eliminate	6.2
Total		224.5



About the Center

The Rhode Island Center for Freedom and Prosperity, a nonpartisan, 501(c)(3) nonprofit public policy think tank, is the state's leading free-enterprise research and advocacy organization. The Center works to make a profound, positive impact on the lives of every family and business in the state through the vigorous exchange of market-based ideas and reform solutions aimed at restoring economic competitiveness, educational opportunities, and ultimately hope for a more prosperous future.

Founder & CEO

Mike Stenhouse

Staff

Justin Katz (research director)

Lawrence Gillheeney (advocacy manager)

Chairman

Dr. Stephen Skoly

Board of Directors

Dr. Phil Cote (vice chairman)

Captain Jay Jacot (treasurer)

Dr. Ellen Kenner (secretary)

Dr. Daniel Harrop (founding chairman)

Judge Robert G Flanders, Jr.

James Lynch

Richard MacAdams

Salvatore Marinosci

Mariacristina McKendall

Joseph Orlando, CPA

Greg Porcaro, CPA

Mike Riley (former chairman)

Thomas Sweeney