

RIDING OUT THE STORM

Tiny Rhode Island has been buffeted by a huge fiscal hurricane that's far from over.

BY NEIL DOWNING

In the summer of 2006, Rhode Island's Republican governor and the state's Democratically controlled General Assembly teamed up to deliver a basketful of tax breaks.

They expanded a statewide property-tax relief program, shielded more cars from local excise taxes, and broadened the state's earned income credit.

But the most publicized piece was a new flat-tax option for calculating Rhode Island's personal income tax, an attempt to make the state more appealing for business owners.

"The very blue state of Rhode Island adopted one of the most sweeping pro-growth tax reforms in any state," *The Wall Street Journal* said at the time.

Three years later, in a rare personal appearance before the House Finance Committee, Governor Donald L. Carcieri proposed a broader list of tax cuts, including a phase-out of the state's 9 percent corporate income tax.

But gone was the bipartisan back-slapping of 2006. In its place were sharp-pointed comments from Democratic legislators and social service advocates who had had enough tax breaks passed in the name of economic development.

"Have we any guarantee that this will help raise jobs that help those who need it most?" asked Representative Thomas C. Slater.

The problem was that this very blue state was very deep in the red.

DEVASTATING RECESSION

Well before Carcieri proposed his plan in May, a full-blown recession had swept through Rhode Island like an ocean-churned hurricane. It had raised unemployment to levels not seen in decades, eroded tax revenue

and made budget deficits balloon.

A key factor was the housing market.

Throughout much of the 1990s, the median price of a single-family home generally followed national trends. But with the new century came double-digit percentage increases in housing prices—each year, for four straight years. From 2000 to 2005, for example, the median price of a single-family home in Rhode Island more than doubled, from \$145,000 to \$293,400.

Some lenders, chasing fees, made loans to people who would not otherwise qualify, the so-called subprime loans that swept the country.

"It's clear the underwriting standards that the mortgage bankers were using were egregious," says Carcieri, a former banker, during an interview at his State House office in Providence.

"There were no appraisals going on, and on top of that, no money down" in many cases, he says. "And it was all predicated on this notion that real estate prices, residential prices, were just going to keep going up forever."

All the while, a state tax credit gave developers incentive to rehabilitate rundown historic buildings. New hotels and high-end condominium projects went up in Providence along with the city's reputation as a hot new destination—for conventions and stylish city living at lower-than-Boston prices.

For a time, it seemed, the party would not end.

But then it did.

Buyers who had overpaid could not afford their mortgages. Tenants could not afford their rents. Condo developers could not sell all their stock. And the bubble began to deflate.

In the first quarter of 2006, the median price of a home in the Providence area was about \$287,100. By the first quarter of 2009,

it was \$202,400—a drop of nearly 30 percent in three years.

In sections of Providence and some other cities, loan defaults and foreclosures soared. Streets became pockmarked with boarded-up buildings. Construction ground to a near halt. And unemployment—especially in the building trades and in mortgage-related services—began to rise.

By late 2008 and early 2009, claims for unemployment benefits were climbing so quickly the Rhode Island Department of Labor and Training had trouble keeping pace. Those who phoned the state's unemployment insurance call center in early 2009 were put on hold for more than two hours on average—assuming they could get through at all.

Between the first quarter of 2008 and the first quarter of 2009, Rhode Island lost 20,300 jobs, according to Edinaldo Tebaldi, assistant professor of economics at Bryant University. By May 2009, the Ocean State's unemployment rate was 12.1 percent—the highest since at least 1976.

"Providence has been doing badly," says University of Rhode Island economics professor Leonard Lardaro in a bit of understatement.

Budget deficits for FY 2009 and 2010 bulged. State officials repeatedly revised their figures as the economy soured and tax revenue slumped.

At one point, Rhode Island's budget gap for FY 2009 was 24.5 percent of general revenues. That was the third largest nationwide (behind California and Arizona), according to the New England Economic Partnership, an economic forecasting organization.

REINING IN STATE SPENDING

Contributing to the problem was a persistent structural budget problem. A key factor was health care spending, says Representative Steven Costantino, chair of the House Finance Committee.

And part of that was a state-run health



REPRESENTATIVE
STEVEN COSTANTINO
RHODE ISLAND

Neil Downing is a business reporter for the Providence Journal in Rhode Island.

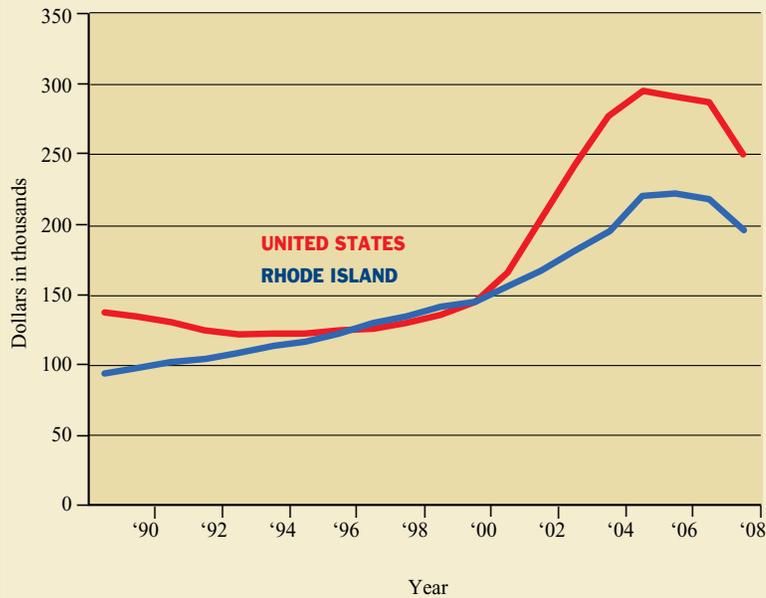
COLLECTIONS OF R.I. REVENUE (DOLLARS IN MILLIONS)

	FY 2008	FY 2009	\$ drop	% drop
Personal income tax	\$955.7	\$798.6	-\$157.1	-16.4%
Sales and use tax	\$775.6	\$747.7	-\$27.9	-3.6%
Lottery	\$296.5	\$279.6	-\$16.9	-5.7%
Fees, fines, penalties	\$291.2	\$233.6	-\$57.6	-19.8
General business taxes	\$234.6	\$208.3	-\$26.4	-11.2%
Total general revenues	\$2,891	\$2,486	-\$405	-14%

Collections from selected sources of state revenue for first 11 months of each fiscal year. "Total general revenues" reflects these and other revenue sources. Dollar amounts are in millions.

Source: Rhode Island Department of Revenue, Office of Revenue Analysis, 2009.

MEDIAN METROPOLITAN HOME PRICES



Notes: * Annual median price of existing single-family homes. * Rhode Island data are for the metropolitan statistical area that encompasses Providence, R.I., Fall River, Mass., and New Bedford, Mass.

Source: National Association of REALTORS, 2008.

plan called the RItE Care program. Although the plan has been widely hailed for improving health care among poor families, that has come at a price. Its costs rose from about \$12.6 million in 1995 to about \$247 million in 2008—an average annual growth rate of nearly 24 percent.

In addition, the state has had to pay more for health insurance to cover current and retired state employees, Costantino says.

"We have a government providing services as if we're still a rapidly growing, manufacturing-based industrial economy," says

Michael O'Keefe, the House fiscal adviser.

Until recently, growth in state spending exceeded growth in inflation and personal incomes, says Gary S. Sasse, director of the Rhode Island Department of Revenue. And the increase in costs for some of the state's largest programs far outstripped annual increases in revenue, adds State Budget Officer Rosemary Booth Gallogly.

Between 1995 and 2009, spending from general revenues rose from \$1.64 billion to \$3.03 billion, an increase of 85 percent. But over the same period, spending on human

services benefits, for example, grew 105 percent, from \$449 million to \$925 million. And state aid to cities and towns rose 143 percent, from \$467 million to \$1.136 billion.

As Rhode Island's structural budget problem worsened, Carcieri and the General Assembly made efforts to tackle it.

◆ Rhode Island sharply reduced its state workforce. In 1994, it had the equivalent of more than 16,000 state employees. By mid-2009, the number had fallen to about 13,600.

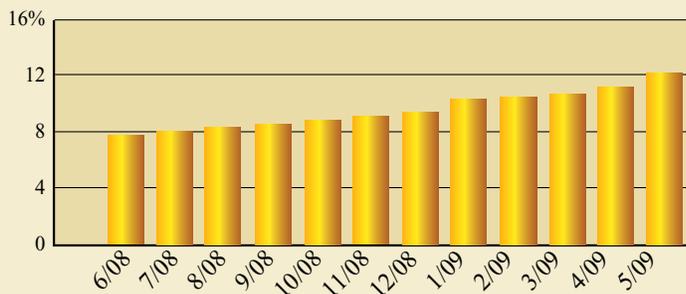
◆ There were no salary increases for state employees in FY 2009.

◆ State employees had to pay a larger share of their health insurance costs.

◆ The state obtained what amounts to a waiver from federal rules governing the delivery of medical services, which allowed it to significantly boost in-home care and other, cheaper alternatives to nursing homes.

RHODE ISLAND'S UNEMPLOYMENT ON THE RISE

Rhode Island's seasonally adjusted unemployment rate has risen sharply.



Source: Rhode Island Department of Labor and Training

DROPPING REVENUE

Spending, however, was only part of the problem, says former Rhode Island Senate fiscal adviser Russell Dannecker.

Because of a range of tax cuts—including breaks for businesses and for the state's highest-income taxpayers—revenue has not kept pace, says Dannecker, now fiscal policy analyst for the Poverty Institute at

Rhode Island College.

The breaks include the flat-tax option, a sharp reduction in some capital gains tax rates, the tax credit for the restoration of historical buildings, and another tax credit for the production in Rhode Island of movies and TV shows. The state has curtailed the tax credits for historical buildings and for TV and movie productions, but the flat tax continues.

“We can’t continue to cut our revenue stream at the top,” Dannecker says, “and continue to cut programs we need for economic development. We have to have a sufficient, fair and equitable revenue stream.”

For the 11 months that ended May 31, for example, Rhode Island’s general revenue collections—mainly from personal income tax, general business taxes and sales taxes—plummeted by 14 percent, or \$405 million, to \$2.486 billion.

Carcieri and legislators locked horns over certain solutions, but found some common ground. In the end, to close a \$357 million deficit, the General Assembly approved a FY 2009 supplemental budget of \$7.2 billion in overall spending. It included a rare drop, of

about \$400 million, in the general revenue budget, which fell from \$3.405 billion for FY 2008 to about \$3.001 billion for FY 2009.

The package included a \$1-a-pack increase in the state’s cigarette tax—to \$3.46 a pack, the highest in the nation—and the use of \$192 million in federal stimulus funds.

That still left a more than \$580 million budget gap for FY 2010.

The General Assembly rejected most of Carcieri’s recommendations for tax cuts, but incorporated a few of his proposals. The final package included a 2 cent increase in the gasoline tax; repeal of favorable tax treatment of capital gains income; changes to the state pension plan; and a 6.125 percent, across-the-board cut in state employee salaries and state government operations. They also used \$236.5 million in federal economic stimulus funds to make the budget numbers work.

Legislators left intact the flat tax, and, in a nod to Carcieri, raised the amount of the Rhode Island estate tax exemption from \$675,000 to \$850,000.

On June 30—one day before the new fiscal year was to begin—Carcieri reluctantly



signed the measure into law.

Overall, the FY 2010 budget came to about \$7.8 billion, an increase of \$427.9 million over FY 2009. But the state’s general revenue budget fell once again, by about \$800,000, to about \$3 billion.

LOOKING AHEAD

“What we’ve done, quite frankly, pales in comparison to what some other states have done,” such as California, says Daniel DaPonte, chair of the Senate Finance Committee.

“As tough as things are here, we’re actually ahead of most states, because we felt it earlier,” says Carcieri. “We’re actually not in the worst shape.”

During a break in the budget debates, Costantino reflected on steps that could boost the state’s economy, such as a runway expansion project at Rhode Island’s largest airport, simplifying the process through which hospitals and other health-care facilities can merge, and speeding up the business use of a former U.S. Navy base.

But the problems have not gone away, DaPonte says. “Things are still incredibly difficult, and they will continue to be so for awhile.”

Andres Carbacho-Burgos, an economist at Moody’s Economy.com, predicted that another 10,000 Rhode Islanders will lose their jobs before unemployment levels out in mid-2010 or so. Housing prices are still falling, and will not begin to rise again until 2011, he said. Federal economic stimulus funds helped to plug Rhode Island’s budget gaps, but will not be available after Dec. 31, 2010.

And the House Fiscal Office forecasts the annual deficit to reach more than \$464 million for fiscal year 2014.

For Rhode Island, that ocean-churned financial hurricane is still swirling.

CHECK OUT how lawmakers in other states are responding to the nation’s deep fiscal problems at www.ncsl.org/magazine.