Rhode Island Policy Reporter

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Intended Consequences

ANY PUBLIC BUDGET is simply a concrete statement of a government's policy, so it's unavoidable that it reflect the priorities of the people in charge of that government. Sticking strictly to the numbers, one can infer the following priorities from the Governor's budget for fiscal year 2007. The fate of the East Greenwich and Barrington school systems is of great importance to him (state aid up 17% for both), while the fate of children in Woonsocket and Pawtucket is apparently far less so (up 1% and 1.7% respectively). He seems to feel it important that people who work for small businesses have access to subsidized health insurance, while people who don't can just suck it up. He apparently thinks that figuring out how to establish a wireless internet network that covers the entire state is more important than taking care of the children whose mothers have welfare benefits that now require them to work all day. And finally, he clearly feels that pretty much nothing the government does is worth raising taxes to fund.

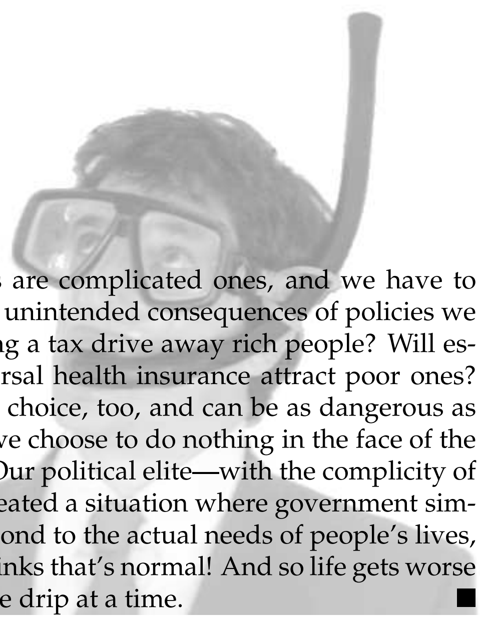
In the budget's introductory text, much is made of the size of the deficit this year: $222 million. This is a huge number, but why is it so huge? Well, a big part of the reason is that federal grants and aid to our state government are going down by $133 million. In other words, 60% of our problem is due to cutbacks at the federal level. The Bush tax cuts on the wealthiest taxpayers are causing the bulk of our problems, and the Governor's response is just to shrug and go along.

With all the budget pain, you'd think we were in a recession, but we're not. There are some very troubling trends at work in our economy, and we can expect trouble ahead, but it's not here yet. Personal income growth in Rhode Island last year was above 5%, and had to be revised *upwards* from earlier forecasts, due to corrected numbers from the US Labor Department's Bureau of Economic Analysis. [See state budget p. ES30.] The consensus projections are that it will decline slightly this coming year, but still remain above 5%. Sales taxes are also predicted to be up 5% this coming year.

So, apart from plummeting federal support, what's the cause of our budget crisis? Mostly health care, for state employees and poor people, with a big assist from rising pension costs. (And the bulk of the federal cuts are cuts in health care, too.) These are problems the government could address, if it would only choose to do so. The state could re-amortize its pension liability (see **RIPR** issue 9). Creating a universal system of health care could provide health care for everyone and control costs in the bargain. But what's amazing is that not only is neither solution on the table for discussion this year, neither *problem* is really there, either. You'd think that fixing our system of health care would be on the agenda until it's fixed, but apparently it's too important to discuss, except to wonder how to provide insurance to some small sliver of the population. Instead we're going to discuss whether rich people should have their state taxes cut, and whether Harrah's ought to have a casino. We'll probably also find time to argue about cutting sick days for state employees.

So what are the real problems affecting people's lives? Consider this partial list: A lack of decent health insurance for everyone? The lack of affordable housing? Increasing job insecurity?

Uncertain and inequitable funding for the education of our children? A lack of good jobs? An unfair tax system?



Our problems are complicated ones, and we have to worry about the unintended consequences of policies we enact: will raising a tax drive away rich people? Will establishing universal health insurance attract poor ones? But inaction is a choice, too, and can be as dangerous as any action. Do we choose to do nothing in the face of the real problems? Our political elite—with the complicity of all of us—has created a situation where government simply will not respond to the actual needs of people's lives, and everyone thinks that's normal! And so life gets worse for everyone, one drip at a time. ■

Assessing Damage

David Segal

Each spring the Governor and General Assembly of the State of Rhode Island play their whimsical games of spending and taxation, but members of city and town councils know the buck really stops with us—not because we want it to, but because there's nowhere left for us to pass it. Cities and towns have powers only within narrow parameters expressly carved out of the ether by state statute. We can't do anything unless the State lets us do it. That's true when it comes to writing zoning code, choosing who can be a street vendor, and deciding what fee we should charge laundromat operators. And Lord knows it's true of setting taxes.

When Rhode Island's well-below-national-average aid to its municipalities isn't enough to fund our schools and departments, we need to make up the gap.

By state law, Rhode Island's cities and towns use modified ad valorem, or "to the value," tax structures, under which a given property is taxed based roughly on how much that property would have sold for when it was last assessed. As most Rhode Islanders know all too well, such a tax structure is quite burdensome, whimsical, and arbitrary. Opening your tax bill can feel like playing the lottery—or Russian roulette. With each revaluation, taxes go down for some taxpayers, while others see increases of four- or five-fold.

But it doesn't need to be this way.

With a few exceptions, Rhode Island's cities and towns tax property and property alone. We can't raise taxes by more than 5.5 percent of the previous year's rate without the state's say-so (not that raising property taxes by more than that is something I'd readily advocate). In Providence, we've been able to convince the State to allow us a one percent tax on meals purchased within the City, and one percent on hotel rooms rented. Though the revenue generated via these sources is less than $2 million—and less than one half of one percent of Providence's annual budget—the institution of these new taxes is a hopeful sign: it is an acknowledgement that there's something undesirable about ad nauseum ad valorem property tax increases, and that the state has a role to play in making things better.

Ad valorem taxes are regressive, by which we mean that, on average, they comprise a larger percentage of a poor person's income than a wealthy person's income. The reverse is true of progressive taxes: poorer people pay a lesser amount of their income than do wealthier people. For example, a structure with no tax on the first $50,000, but high taxes thereafter, is progressive. One with taxes on the first $50,000, but none thereafter, is regressive. Progressive taxes are fairer, as they facilitate the redistribution of wealth from the rich to the poor, while regressive taxes tend to redistribute wealth from the poor to the rich—and that's just mean.

In particular, ad valorem taxes are regressive because on average, the ratio of house value to income is higher for a poorer family than a wealthier one. If taxes, for everybody, are a direct function of current property value, then the ratio of taxes to income will also be higher for a poorer family than a wealthier one.

The devil's in the details, of course: broad categories of taxation like "income," "sales," and so on, can generally be structured so as to be either progressive or regressive, and to varying degrees. Our federal income taxes are progressive, with marginal rates that increase with income,

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Who needs a nicer neighborhood?

Under our current system of property taxation, even certain neighborhood improvements that are thought to be unambiguously good can be problematic. Planting street trees or putting in new lighting can yield double-digit percent increases in values of neighboring property. Under today's tax structure, that would usually yield increased property taxes and increased rents. Under the RightTax model, this effect would cease to exist. Though a neighborhood's desirability will make rents rise through market forces, it won't be the city forcing rents up from property tax increases.

My ward includes several blocks still occupied in large part by Portuguese immigrants from the early and mid-1900s. (Many of them, in fact, still manage to get by without speaking English.) They live in one of the tiny pockets of the East Side that has yet to be completely gentrified, and which is noticeably less affluent than neighborhoods just a block or two away. Also evident is a general dearth of street trees—a function of the City's neglect, and traditional cultural priorities of the Mediterranean (where fruit-bearing trees are highly valued, and street trees not-so-much). Residents of that neighborhood deserve trees just as much as residents of any other neighborhood do. But to plant them would increase property values, and with them rents and taxes, burdening precisely those who've been able to withstand the last 30 years' gentrification of Fox Point. DS

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though they're not as progressive as they were before the Bush tax cuts. Sales taxes on everyday food items are generally regressive, because poorer people will spend a greater portion of their income on food than will wealthier people. Sales taxes on Fabergé eggs are progressive, since poor people don't buy Fabergé eggs.

A system of property valuation that depends on purchase price may be a fairer way to assess these taxes.

RightTax, a group led by Harvey Waxman, a retired dentist in North Kingstown (see the *RightTax.org* web site), advocates for what it calls a "Property Owner's Tax." It is right to point out that under our system, since an individual's taxes are a function of the market value of his or her home, those taxes are based not on his or her income, but on what *other* people—potential buyers—can afford to pay.

RightTax suggests a new tax code, modeled after one that's been used in California for twenty-six years: property owners would be taxed, forever, based on what they paid for the property they own. A thirtysomething couple that buys a $300,000 house in 2005 would be taxed based on $300,000 of value, even in 2045, when they have retired and are living on a fixed income, and their home is worth $3,000,000 on the market. Tax rates would still go up or down, depending on budgetary needs and the total value of property within a jurisdiction. But the distribution would be based on what owners were able to afford when they bought their homes, rather than on what somebody else can pay at tax time.

The RightTax plan would shift the property tax burden to newer owners, who, by having purchased a given home, will have demonstrated an ability to pay its taxes. In a world of rapidly rising real estate prices, such a code could make buying a first home more difficult, and so should include hefty exemptions for lower-income first-time owner-occupants. It would also make sense to inflate property values slightly (and fairly, and predictably) year-by-year, perhaps by the rate of wage inflation, to smooth out some of the disparity between old and new.

Under this tax code, no longer would unpredictable, rising taxes force elderly residents to leave the neighborhoods they've lived in for decades. Landlords wouldn't feel as much pressure to hike rents. Property owners could make improvements without worrying that doing so would drive up their assessments. Rampant speculation wouldn't drive up taxes for whole neighborhoods. City planners could make decisions with less fear of contributing to forced gentrification.

Cities and towns wouldn't need to spend millions of dollars on revaluations every three years. Property owners wouldn't go into shock when they open their tax bills.

Property taxes need not be unfair and overly-burdensome. They are that way because of how our state has chosen to implement them. The General Assembly should pass legislation allowing municipalities to tax property based on purchase prices, while also leaning more on other progressive taxes, like the income tax. ■

GASB and Portraying Reality

Lurking in the offing of this year's budget are some profound changes in the rules about how governments account for some expenses. The rule changes are going to raise all our taxes, for no good reason, and constitute a kind of cosmic joke at the expense of politicians who espouse "conservative" economic views. Before discussing the new rules, it's worth introducing the rule-makers.

The Financial Accounting Standards Board (FASB) is a group of accountants brought together in 1973 to establish the rules of corporate accounting on behalf of the federal Securities and Exchange Commission. There is a lot of discretion involved in accounting expenses at some corporation—is this expense a current expense or a capital expense? Is that payment from routine business practices, or is it a windfall? FASB was established to standardize many of these decisions. They publish a set of guidelines called the Generally Accepted Accounting Principles (GAAP), and these are what accountants use to audit corporations (and to run them).

These accounting principles are not universal. Insurance companies and banks are businesses that require rules that differ from the GAAP. When you give an insurance company some premium money, you enter into a different relationship with that company than when you give some money to a cleaning service, and deposits at a bank are a different matter still. You could run an insurance company with accounting principles meant for a cleaning service, but when you wanted to ask important questions like "Are we making money?" or "What should our premiums be?" the answers would be misleading. Therefore, there is an entirely different set of accounting principles for insurance companies, developed by the National Association of Insurance Commissioners, and yet another for banks, developed by the Federal Reserve.[1]

Accounting rules are all about the portrayal of reality, but they are not reality. If you were a landlord making some repair to a house you rent, you might classify that repair to be a maintenance expense, or it might be big enough that you might decide it was really a capital expense. One choice will lead to a certain set of actions,

[1] There are serious difficulties with controlling premium inflation with the accounting rules for insurance companies. These are not relevant to the discussion at hand, but see **RIPR** issue 3, available at *whatcheer.net*.

while the other choice will lead to a different set. Deciding that it was a capital expense means that you might depreciate its cost over several years when you go to calculate your income tax, while a maintenance cost can be deducted right away. But neither choice makes any difference at all to the roofing company who did the work; they only want to be paid. How you choose to portray the expense may make a difference to you going forward, but it doesn't affect the underlying reality of the transaction.

Accounting rules are about the portrayal of reality. They are not reality.

You can also taste the arbitrary flavor of the rules in the way that even under the GAAP principles, there are two systems. A company can account for its expenses when the payment is actually made (the "cash" system) or when it is promised to a supplier ("accrual"). Some accountants prefer one system over another, but the two are both valid portrayals of a business.

With all this background, let's introduce the Government Accounting Standards Board, founded in 1984. GASB is another private group of accountants associated with FASB, whose job it is to establish accounting rules for governments. The GASB rules are widely adhered to,[2] and auditors refer to them while conducting their audits. GASB has recently made two important changes in accounting procedures that will have essentially similar effects: Statements 43 and 45. These will require that as of 2008, governments account for the costs of health and other benefits they pay to their retirees in the same way that they account for pension costs.[3]

These rulings say that the expense of providing some post-employment benefit was incurred when the employee earned it. This sounds reasonable, but the practical effect is that unless a government plans to fund these future expenses out of investment income, *and* already has the funds put aside for that purpose, it must show an "unfunded liability" for the future amount on their books today. Towns, cities and states who will be perfectly capable of paying these expenses in the future will appear to have budgets in deep deficit. The accounting change will make Rhode Island's 2008 budget appear to be in a $629 million hole that isn't there in 2007.

Rules meant for corporations aren't necessarily right for governments, even if they sound right.

Funding this kind of expense out of investment income is obviously desirable. But like many obviously good ideas, there are hidden factors that complicate the picture.

By the calculation of our actuaries, RI has a $629 million unfunded liability due to its promises to fund the health insurance of state retirees [ES11]. This is the present value of our promises, estimated out a few decades or so. This is a lot of money, but in a just world, there would be several different ways we could choose to address this problem. We could figure out some way to put aside $629 million and invest it, and fund the costs from the investment income. This will inevitably mean big tax hikes, big service cuts, or big luck. Or we could fund the ever-increasing amount out of tax revenue, which is what we do now. Or we could invest $629 million in the education of our children, or in our universities, and allow the resulting growth in our economy to cover the added costs. Or we could take the hint, realizing that it's more than just state retirees who are having health insurance problems, and spend $629 million to create an equitable and just universal health care system that saves money for all of us. Or we could leave the money in our citizens' pockets for now, and and figure that the growth in personal income over time will be more than enough to pay the cost when the bill comes due.[4] But according to GASB, only the first of these will do, and the Governor plans to meekly knuckle under.

An investment in education is just another liability according to GASB rules.

By demanding adherence to their definition of fiscal prudence, GASB—an unelected, private group of accountants in Connecticut—insists that our government *not* act to solve our problems in any way that they didn't think of already. To their credit, GASB does say that Statements 43 and 45 don't demand that the unfunded liability must be paid off, only that it be shown clearly on financial statements. But they don't have to demand it. When it appears, people like the Governor demand it for them when they look at the state's balance sheet and see the huge "liability."

The secret joke in all this is that self-proclaimed economic conservatives, like the Governor, don't object to these GASB rules, even though their implication is that funding government expenses in a "fiscally prudent" manner is a higher good than the economic growth possible by leaving this money in private hands. Governments do more than collect and spend money. Some of what they do is actually helpful to people, and some is

[2]But not universally. The U.S. government has its own rules, and does not follow GASB rules for capital expenses.

[3]There is more about funding of public pension costs, including a comparable critique, in **RIPR** issue 9, February 2005.

[4]And yes, the rates of return would be comparable. Over the past fifteen years, personal income tax collections have increased around 3% faster than inflation every year, despite two recessions. This is a respectable rate of return, and unlikely to be much surpassed by any government financial investment, which tend to the conservative.

also helpful to economic growth. Unlike any corporation, a government has a claim on the income of its citizens, and this means that a far wider variety of useful investment is possible. The future of any government depends on the future income of its citizens and—as is endlessly pointed out in other situations—it is in the best interests of a government to act to increase that future income.

But the new GASB rules effectively demand that governments raise taxes in the near term, rather than leave the money in the hands of individuals and businesses who might invest it in other ways. Defending this kind of accounting is a curious position for a protector of the free market to take. ■

More tobacco money? Where did that come from?

The budget this year contains about $250 million in proceeds from the tobacco money. For those late to the party, here's a recap. As part of the giant suit against tobacco companies settled a few years ago, Rhode Island was awarded around $55 million dollars per year for health care costs created by the sale of tobacco, in perpetuity. In 2002, the state sold the rights to a couple of decades of that income to bondholders, who paid $685.39 million for the privilege of receiving it. We used $295.3 million of that to pay off old debt, and the rest was used as general revenue to balance the budget in 2002-2004 [ES19].[a]

Due to uncertainty in the tobacco companies' financial position and new vulnerability to more suits, the repayment of these bonds uses all the tobacco income. (This is referred to as "turbo" in the trade. Other states who issued bonds for their tobacco income assigned some of the tobacco money to bonds and some to current income.) The tobacco income turned out to be higher than anticipated, and it now appears that these bonds can be retired in 2023, earlier than was expected when they were issued. The state is proposing to sell a new series of bonds to assume the income beyond 2023, and this sale is expected to net $200 million.

Of that money, $100 million is slated to go toward a fund to pay for health care for retirees (see article) and the other half to establish the "Trust for Rhode Island's Health Insurance." My heart quickened when I read that title, but it appears that this will only be an endowment to provide a subsidy to help small businesses pay for health insurance. This is no small thing for those businesses, but won't do much for the rest of us, who are also struggling with health care costs.

In addition to this, a $49 million escrow account has become available. This is money we put aside years ago to guarantee some bonds that were paid off by the 2002 sale [ES40]. This money is slated to go directly into the general revenue, and be spent on this year's expenses.

[a] Also see *http://www.bos.frb.org/economic/neff/neff30/tobacco.pdf*.

Budget Notes

Some random thoughts and facts about the Governor's proposed budget for fiscal year 2007.

The big audit The Governor makes a lot of rhetorical hay with his "fiscal fitness" audit which has supposedly shone a spotlight on waste all over state government. But any honest audit of an organization is as likely to find places where a significant investment up front could save money later as it is to find money wasted by inefficient spending.

For example, could the big audit really have checked out the Department of Transportation, where they routinely borrow $30 million each year, come rain or come shine?[5] **RIPR** issue 7 (October 2004) contained an analysis that pointed out that DOT borrowing cannot be justified in the usual ways one justifies taking on debt. It's an expense, already amortized at $30 million a year, and continuing to pay for the department activity this way is no more responsible than paying your rent with credit cards. The difficulty is that fixing this problem—and saving money in the process—would require the Governor to *add* $30 million to the budget in one year, instead of the $3 million snuck in every year [B407].

A Governor who had had this kind of courage could have stopped this practice a decade ago, and saved us much more than $30 million by now. But brave ones seem fairly scarce.

Squishy welfare numbers The welfare "reforms" the Governor proposes are little more than service cuts, and are presented in a somewhat odious fashion. For example (one out of eight from p.ES7):

> Increase the work requirement for two-parent FIP recipients from 30 to 35 hours per week… for a savings of $1.3 million in general revenue.

In other words, the savings estimate assumes that many families will not comply with the new rule.

Interestingly, when capital gains tax cuts are discussed, it is claimed that cuts in that tax will change people's behavior: they'll invest more and save more. So the claim written between the lines of the budget is that rich people will respond to financial incentives, but poor people do not. If they actually do, the savings will not happen, and the budget will not balance. If they do not, they might be refusing because they indeed are recalcitrant parasites on the body politic, or it might be because they cannot.

Helpfully, the budget also tightens the eligibility rules for the child care subsidies that many of these families rely on, decreases the amount subsidized, and delays an already scheduled rate increase for the child care

[5] As of this writing, the FY07 capital budget was not yet finished, so it's not perfectly clear what the DOT intentions are, but the executive summary implies that a continuation of past practice is in the works.

providers. These, um, purely technical adjustments will help insure that the budgeted savings in welfare spending materialize.

Local budget limits Right now, state law limits how much town budgets can grow each year to 5.5%. We all agree that property taxes are too high, but simply demanding that they be lowered is not very helpful to the people who run those towns. After all, they tend to live in those same towns, and tend to pay those same taxes. You don't run for town council by promising to raise taxes, but somehow the Governor imagines that there's something intoxicating about the oath of office, transforming sober citizens who ran on promises of fiscal responsibility into drunken sailors, spending without restraint, and so his budget proposes tightening the annual cap on town budgets to 3.0%.

Similar limits exist in other states around the country, but what people have found is that in a world of dramatically rising health care costs, this is a recipe for disaster. Last fall, Colorado voters rejected these kinds of limits after a decade's experience with them. But, refusing to learn from someone else's misadventures with these limits, the Governor wants to impose them on us. Ask your local town council members whether they think their inability to keep taxes down would be helped by simply having the state insist upon it.

Car tax The continued phaseout of the property tax on automobiles is another strange priority. After all, if you have a car, the first $5,000 of value are *already* exempt from property tax. The proposed change will affect only people whose cars are worth more than this. Cars are expensive these days, but there are a lot of clunkers still on the road. Presumably the people who drive them can't afford something better, but presumably tax relief is only meant for people who can.

This change will cost the state $11.2 million over the 2006 budget. About half of that is to be increased funds from video lottery terminals at Newport Grand and Lincoln Park, with general revenue making up the rest [ES9].

Medicaid The budget proposes large cuts in the state's Medicaid spending, including taking all undocumented immigrant children off the program to save $4 million, and cutting out now-eligible adults (many of whom already are charged a co-pay for the insurance) to save another $10 million or so.

In addition to this, the Governor suggests increasing the efficiency of Medicaid spending. The two biggest components of Medicaid expenses are health care for the poor (which is mostly provided by Neighborhood Health Services, a non-profit that runs a series of small managed-care clinics) and support for nursing homes [B257]. It's certainly possible that there is substantial waste and inefficiency in the state's Medicaid spending. But if you had to guess where to find it, would you look first in the non-profit aid-to-the-poor side ($436 million), or would you look at the state's many for-profit nursing homes ($304 million)? The Governor's budget lists 15 "operational efficiencies" in Medicaid. Fourteen of them, making up 90% of the savings, are cuts in service to the poor. ■

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