Rhode Island Policy Reporter

Issue 10 **15 April 2005**

Choosing a crisis

As in many recent years, schools across our state are in financial trouble this spring. Teachers, counselors and nurses are to be laid off in one town, neighborhood schools are to be closed in another, and most everything resembling a frill is pretty much history all over. Despite the cutting and slashing, however, property taxes to fund our schools (and municipal services) are higher than ever, and getting higher. Across the state, the same scenes are being played out in city council and school committee meetings, where the voices of reason insist that the only responsible thing is to slash spending, because there simply isn't any money to fund these nice things any more.

And yet, consider this. From 1991 to 2001, the US enjoyed one of the longest and most substantial economic expansion in modern history. The economy hasn't done as well since 2001, but even measured from 1991 to 2005, we're doing fine, averaging over 3% growth per year. Wages have been stagnant for a long time, and though they haven't kept up with inflation over the whole period, they made big gains in the late 1990s. Our nation's international trade position and the federal budget idiocy make for some very dark clouds on the economic horizon long-term, but in relative terms, what we've got on our hands right now isn't even a light drizzle, let alone an actual storm. Retail sales are up around 50% from 1990.[1] Rhode Island's unemployment rate is only slightly above the lowest it's been in 15 years, and declining. We have tens of thousands more jobs than we had 15 years ago, and around the same number of people. As the Governor's own budget has it, "Rhode Island's economic performance in 2004 has been nothing short of remarkable."[2] Why, then, are we having so much trouble paying for our children's education?

[1] All calculations are in constant 2005 dollars, unless otherwise noted.

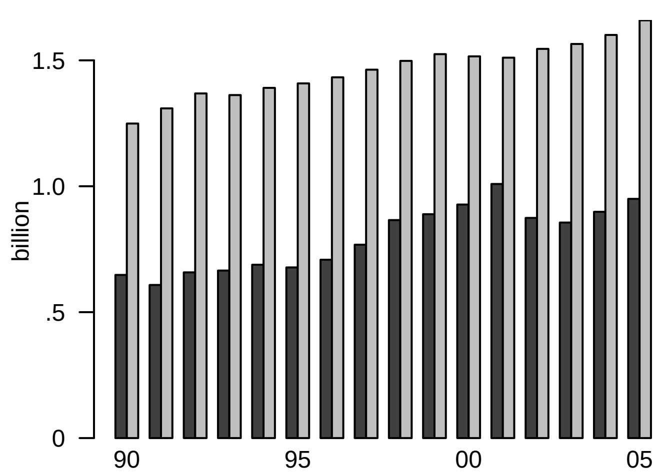

Figure 1: Property tax and income tax collections, 1990-2005 (odd years). The total property tax collected by all the towns in the state is shown by the tall pale bars. Since 1990, property tax collections are up 33%, but income taxes are up 47%, almost half again as much. This is despite the fact that the income tax rates have stayed constant or declined for most over this period (and we've had two recessions), and the property taxes have shot up.

The conventional wisdom seems to be that the reason for this is exploding costs. In a sense, this is obviously the case: if the costs weren't rising, there wouldn't be a crisis. But simply knowing that costs are rising tells you precisely nothing about whether the increased spending is unjustifiable or unnecessary. Claiming otherwise without close examination is the mark of someone who isn't really interested in solving problems. RIPR will spend more time with education costs in a future issue.[3] But for now, consider that we ask our schools to do more than we did even as little as 15 years ago. Two examples: special education has brought kids once deemed "ineducable" back into their communities, and state law now requires school systems to spend a great deal more on transportation than in the past. For most communities, these are both huge new expenses, leaving it somewhat less than a surprise that property taxes collected statewide have risen 33% since 1990. On average, you're paying a third more property tax than you did 15 years ago.[4].

But what may be a surprise to some is that during that same time, income tax collections have risen almost half again as fast: up 47%. What's more, over that same period, the effective state income tax rates have remained roughly constant or declined for most taxpayers, while property tax rates, um, haven't. And though this period includes the dramatic economic expansion of the 1990's, it also includes two recessions. We're collecting a lot more tax, but on average, you're paying state income tax at the same rate or significantly less than you did 15 years ago.

A thought experiment Let's imagine what would happen if taxes were raised in an essentially unfair way: arbitrary and overwhelmingly high, for many people, but low, on average. Say you have a sales tax that's only one percent for everyone whose last name starts with the letters A through U, and 50% for the poor unfortunates

[2] FY06 Budget, Executive summary, p.21, where you'll also find a more extensive discussion of how remarkable it is.

[3] And in past ones. See issue 9 for an analysis of the rapidly increasing teacher and state employee pension costs, for example. The Governor is not a disinterested bystander in the dramatic cost increases this year (and next and the one after that). His choices have made a bad situation much worse. Issue 9 and other back issues are available at *whatcheer.net*.

[4] And yes, this is true even if you rent. Few suspect that property taxes come out of a landlord's pocket, and that is part of our problem, discussed on page 4

whose names bring up the rear of the alphabet.[5] On average, the tax would be around 4%, a bargain.

So this is hardly fair, but how would the events actually play out? We'll assume that the tax would be eventually overturned, but what would happen on the way? Overall, the tax rate isn't huge, but people often don't make decisions based on aggregates. People make decisions about their own circumstances, and what they observe directly or hear about, and what many would see in our hypothetical case is that they would be paying much more tax than they could afford.

After a while those taxpayers would realize that there are many others in similar situations, and perhaps they would organize, to make their concerns more widely known. Having been told that the state constitution requires this kind of arrangement, perhaps their organizations would bring pressure to bear on local government to restrain spending, and perhaps they'd be able to enlist the aid of other people, who might not be as badly affected, but who can see the injustice of the situation. As government costs went up, increases in those taxes would have to be discussed. A 10% increase would bring the alphabetically challenged taxpayers' rates up to 55%, while the rest of us suffered under a 1.1% rate. I, of course, would have no problem with that, and might not bother showing up at hearings, but someone named Walsh would, and with his friends the Vennerbecks, Xaviers, Yorks and Zacharys, he'd be right to complain, loudly. But establishment policy shops could readily provide average statistics to prove that the tax burden is far from out of control. They'd say, but hey, the overall rate is still only 4.4%, and still a bargain.

The point of the example is that under an essentially unfair tax, rankling and outright rebellion will happen long before the average burden is unsustainable. It will look like complaints about spending, but it will happen *because* of the unfairness of the system, not the size of the load. Looking at who pays the tax is not just a detail; single numbers that are supposed to describe our tax system can be very misleading. The distinction between progressive and regressive taxes is not just academic. It has real consequences, and one of them is property tax riots. When discussing taxes, it's simply not good enough

[5]This is about 6% of the population, according to the distribution of names of members of Congress.

Rhode Island Policy Reporter
What's really going on, instead of what's said about it.
Box 23011, Providence, RI 02903-3011
www.whatcheer.net/ripr ⊛ *editor@whatcheer.net*
subscriptions: $35/11 issues, $20/6 issues
editor: Tom Sgouros
Issue 10 ⊛ 15 April 2005 (1.4)
©2005 Tom Sgouros

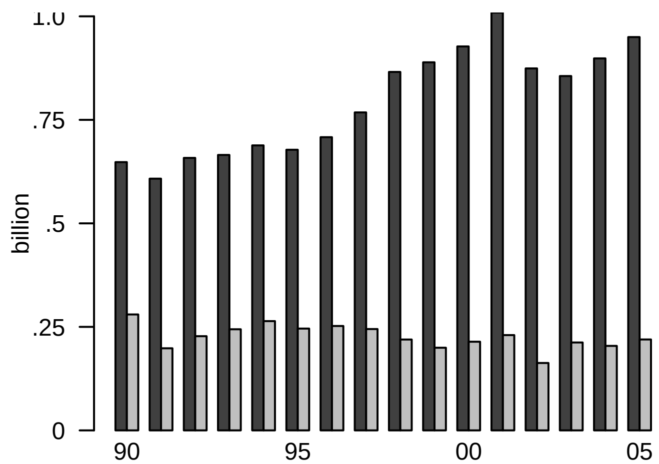

Figure 2: Personal income taxes (dark) versus business taxes (light), 1990-2005. Over the past 15 years, a succession of corporate tax breaks have brought the contribution of businesses to state revenue to from significant pillar to near irrelevance. If you ask most businesses which tax is the most onerous, they'll almost all say the property tax. But the business income taxes are what we've cut. See page 5.

to look at what the overall level of tax is in the state. You have to look at where the burden falls, or you risk making idiotic tax policy decisions like this.

The real world The real world tax policy decisions we've been living with over the past fifteen years haven't been so very different than this. Motivated by some report from RIPEC or the Tax Foundation or the Heritage Foundation that ranks Rhode Island's tax burden in the top 5 or ten or whatever, our lawmakers repeatedly set out to raise no tax at all. Some years they succeed and some years they only succeed by shifting the burden to the towns.[6] Some years the towns hold the line, and some years they can't. But all the pressure is from the state to the towns. There is no leverage in the other direction, and so the burden moves to the payers of the property tax, which is regressive — when it's not crazy.

Here's another thought experiment. For those who own houses: ask yourself and your friends, Could you afford the house you own, were it to come on the market today? For those who don't own their home, ask instead, Could you afford to move anywhere in the state that you'd actually choose to live? The answer, almost universally, is no — something all Rhode Islanders can share.

The real estate market is so crazy now, and has been so crazy for so long, that unless it was purchased quite recently, the value of one's home is very likely not at all a good measure of one's income. The officially assessed

[6]Or by not assuming what they'd planned to. Under Ed DiPrete, the stated goal of the administration was to move toward the point where the state picked up 60% of the statewide cost of education. Now it's hard to find legislators who think it could get back up to 50%.

value, depending as it does on all kinds of assumptions and statistical artifacts, is likely even worse.[7] The result is that you have people whose taxes bear little or no relation to their ability to pay, and that are regularly subject to huge swings during revaluation years. When these people show up to complain about property taxes at town council meetings, they are outraged, and it's usually justifiable. How can you blame someone who has just been told they can no longer afford to live in their own home?

Over the course of the past 15 years, municipal education costs have risen, but not faster than the growth of the economy, nor even faster than other parts of state government. But during that time, Rhode Island has allowed the increases in education costs to be assumed by the most arbitrary and least fair tax we have. Should we be surprised that tax revolts are a harbinger of spring around here?

What can we do? If you see the problem before us as an unsustainably high tax burden, as the Governor clearly does, there is only one responsible course of action: cut. Cut everything, cut desperately, and cut deep. But if you wonder why we can't seem to pay for what we can afford, perhaps looking for a solution that involves readjusting the distribution of the burden is a better idea. After all, the first involves cutting what doesn't really need cutting, and some of that stuff is valuable.

As was noted above, over the past 15 years, income tax collections have risen, despite two recessions. In 1997 Governor Lincoln Almond enacted a 10% income tax cut, phased in over five years. For many people in Rhode Island, the income tax is so low they didn't even notice. Legislators have noticed this, and over the past couple of years, some have proposed bringing the income tax back to the bad old days of 1996. This would be a 10% hike in the tax, and would bring in around $100 million in increased revenue to the state. Other modifications are possible. Rep. Tom Slater (D-Providence) is sponsoring a bill this year to restore the Almond tax cuts on taxpayers earning more than $200,000. This would raise $35 million by RIPR calculations.

These are useful proposals, if the goal is to raise a little bit of money for the state to keep important programs from being cut. But they do little to address the overall fairness of the tax system. To do that requires shifting large amounts from one column to another, for example, from the regressive property tax to the progressive income tax.

What would such a shift look like? Part of it would look like a tax increase, of course, but the other part would look much better. Suppose we raised the income tax 10% on everyone, and applied it all to property tax relief. This would allow a 7% property tax cut for everyone. Anyone whose state income tax bill is less than 93% of their property taxes would wind up with a net tax cut. Most people have to be earning well over $100,000 a year before they pay as much income tax as property tax, so this proposal would actually result in a net tax cut for around 95% of

[7] There's more about this in RIPR issue 6, but aside from providing more evidence of the essential unfairness of the property tax, it's a little off-topic for now. Find back issues at *whatcheer.net*.

Another tax primer

During the heyday of the American Populist movement, in the 1890's, it wasn't considered unusual for Wisconsis farmers to attend lectures given by other farmers about international economics and monetary policy. These farmers realized that these arcane points of policy had a huge impact on their lives, and so they studied in order to change the system. When William Jennings Bryan talked about not crucifying labor upon a cross of gold, he could be certain that his audience would get not only the religious significance of his words, but also that they understood what a tight money policy really meant in terms of farm prices and wages.

Before our tax system is fixed, we'll have to get to the point where it's not considered necessary to explain what a progressive tax is before discussing them. But we're not there yet. So for those who need this vital piece of intellectual equipment before proceeding into the swamps of analysis in the accompanying article, here it is.

A progressive tax is one where the higher your income is, the higher a percentage of your income is paid in tax. The federal income tax is the best example, though its a lot less progressive than it used to be. The richest 20% of families pay federal taxes at a rate around 27%, according to the Congressional Budget Office,[a] while the poorest 20% pay around 7%. The idea is that someone earning $800,000 taxed at 27%, still has almost $600,000 left over, while someone earning $16,000 can't afford to give up as high a proportion of their income.

A regressive tax is the opposite: one where the poorer you are, the higher proportion of your income is paid in tax. The sales tax is the classic regressive tax, since poor people spend all their income, so all of it is taxed, while the wealthy can afford to sock some away, where it isn't. The sales tax can be made less regressive by exempting some items, and Rhode Island, where we exempt food and most clothing, does pretty well here.

In a stable real estate market, the property tax is regressive. Someone who earns $500,000 is not likely to live in a house worth ten times as much as the person who earns $50,000. It will be worth more, but probably not by a factor of ten. But in the kinds of real estate markets we've suffered under, there is an additional element of randomness thrown in, where some revaluations seem to favor wood over brick or views to the east over views to the west.

[a] Though many pay considerably less. George W. Bush earned $822,126 in 2003 and paid 227,494 in tax, putting him at 27.6%, right on target. Dick Cheney reported just under $2 million in income in 2003, but paid $248,369 in tax, for a rate of about 12.5%.

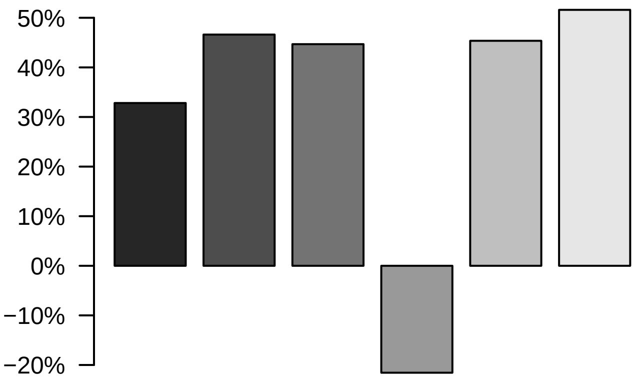

Figure 3: The mystery graph. What's shown here is the increase since 1990 in the collections from various taxes and other numbers. Pictured are the growth of our economy, the total state budget, the property tax, the income tax, the sales tax, and the business income taxes. The problem is to guess which one is which. It's probably not what you think. (Answer at the bottom of the page.)

the state.

The logic works at more generous levels, as well. Were we to double the state income tax, and apply it to relief of property taxes, we could cut property taxes by 60%, have $200 million left over, and between 85% and 90% of the state would still be paying less in taxes. For the wealthy whose state taxes would increase, the change would be a bit smaller than the benefits of the Bush tax cuts they've received since 2001.

A little bit more detail. In North Kingstown, you are probably earning more than $99,000 before your income tax exceeds 60% of your property tax. In lower-tax Narragansett, the number is more like $77,000. In Providence, the number is nearer $122,000. Statewide, around 10% of filers claim more than $100,000 in income on their tax forms, and about 20% have income greater than $75,000.

There is a great deal that is appealing about a scenario like this, mainly that it makes our state's tax system more progressive, relieving much of the unfairness of the current system. But it's one thing to contemplate the perfect world, and it's entirely a different one to create it. There would be a host of knotty problems to untie.

One of the most significant obstacles is landlords. How do you get the tax relief past them and to the people for whom it's intended? Counting on landlords to lower the rent is probably not a good strategy. A rental tax credit is one way to do it, though there would be a certain amount of overhead to manage it. This is a hard problem, but rather than take it as discouragement, let it illustrate a more important point: it's much harder to undo bad policy than it is to keep from making it in the first place. Acting may be hard, but not acting will be worse.

Another problem is that some towns benefit a great deal from the property tax. These are the seaside towns with lots of out-of-state landowners. The multimillion-dollar beach homes in Narragansett are what allow the taxes to remain low on the rest of the town. These towns might find it best to provide property tax relief via renters-and-homesteaders exemptions on people who actually live in town, in order to preserve the income from their out-of-towners.

Yet another potential obstacle was outlined by a town councillor I spoke to recently. He said that it sounded interesting, but you had to look at the whole context, and cautioned me that CVS's Tom Ryan might flee the state, taking his zillion-dollar income with him. Concern about the unintended consequences of policy is important, but paralysis is also a problem. Rich people might flee, and they might not. One can't know in advance, and one certainly can't find out by asking. But it is not true that action is less responsible or more risky than inaction. They both constitute a choice: one chooses to try a solution, and the other chooses not to. This caution is the false "responsibility" of those who would watch the house burn rather than risk the water damage. We have a lot of these people around, though, and they will be (and have been) a serious obstacle to change.

Trust Towering over these cavils, however, is the real obstacle, the one that has, until now, prevented our government from addressing the inequities of the state's various tax laws: trust. The Governor and state legislators don't seem to trust the towns with increases in money and the towns don't trust that the state will pay what it promises.

Data sources

You can get employment statistics about Rhode Island's economy from the Federal Bureau of Labor Statistics (*stats.bls.gov/eag/eag.RI.htm*) and the Bureau of Economic Analysis (*www.bea.doc.gov/bea/regional/gsp*). The other data in this article was culled from state budget documents. Property tax data is from the RI Office of municipal affairs. See RIPR issue 2 for an analysis of the incidence of property and income taxes in two municipalities.

You can also find income distribution data from the IRS Statistics of Income reports (*irs.gov/taxstats/indtaxstats*). Unfortunately, as of the 2002 tax year, the IRS stopped providing detail about the upper income tax brackets. Presumably there is an innocuous explanation for this, but it would be hard to believe it. The changes mask the benefits of the Bush tax cuts on the very richest taxpayers, and they make it more difficult to see where the data contradict the Congressional Budget Office estimates of the taxes paid by the top brackets (which they do). I know you're as shocked as I am.

Oh, come on, you weren't really trying. Answer on the next page.

(And our city councils don't really trust their school committees, either.) Until the fundamental relation between the state and the towns is repaired, reform will be elusive.

The obstacles to this kind of reform are many, but the goal is well worth it. Fixing the way we fund education is the Gordian knot of Rhode Island policy: hard to unravel, but well worth taking the time to try. At least things worked out pretty well for the last guy who managed such a trick.

Difficult is not the same as impossible. One way to manage the trick is to get courts involved. Over a dozen years ago, after a court ruling unfavorable to the current method of funding education, much talk was heard about a Guaranteed Student Entitlement — an amount of money that each student in every town would be guaranteed for their education — and how this could be written to become an enforceable compact between towns and the state. Because no politician at the time was willing to suggest the tax changes necessary to fund such an entitlement fairly, and few towns were willing to submit to the budgetary scrutiny such a proposal entailed, the whole project faded to obscurity. But its failure had more to do with a lack of political courage than with the merits of the idea.

I'm with Tolstoy: saying that we as a populace "choose" this or that is a convenient, but terribly misleading metaphor. "We" didn't choose to have a crisis in school funding. But it was choices, made and followed by popular Governors (and legislators, though they're less popular), that have caused this crisis. It is a crisis by choice.

So how did these choices cause a school funding crisis? By creating a fundamentally regressive tax structure. How do we fix it? By making the tax code more progressive. Admittedly, this answer contradicts the conventional wisdom about government spending and the tax burden, but if the conventional wisdom were always correct, wouldn't we be living in an earthly paradise? ■

Spending

Unaccountably, when the subject turns to taxes, RIPR is regularly accused of ignoring spending issues. Since it's hard to type more than one thing at a time, it's hard to know just what to make of this criticism. But you can find plenty of suggestions about opportunities to cut state spending in back issues. (Check out 1,4 and 7 for example.) The February issue contains a loving look at the math behind the recent pension increases. Go slake your insatiable thirst for policy exposition at *whatcheer.net*, where you'll find all the back issues. Then subscribe. You'll get future issues in the old-fashioned US mail, filled with information and suggestions that — for better or worse — you won't find in many other places. $35/11 issues, address on page 2, or pay online with a couple of clicks. –TS

Book Review

Cut it and will they come?

Rethinking Growth Strategies: How State and Local Taxes and Services Affect Economic Development
Robert G. Lynch, Economic Policy Institute, 2004

Fidelity, Alpha-Beta, GTECH, American Power Conversion, the Providence Place Mall. All of these corporations have received special tax concessions from the state of Rhode Island over the past few years. Some of these deals work out as planned, and others don't. But they all cost money. Sometime concessions are extracted in response, but the follow-up to those concessions is usually weak or nonexistent. (Where is the downtown movie theatre once promised by the mall? How many APC jobs did eventually go to welfare recipients? Where's the massive expansion Fidelity predicted?)

Rhode Island sits squarely among other states in the use of these concessions. We're part of a national trend, and it's part of the reason why the business taxes bar in the chart on page 4 is negative. But the underlying logic behind these concessions has always been more than a bit suspect. Businesses create jobs, yes, but businesses also rely on police and fire protection, require good roads and other transportation, expect not to have to teach their employees to read. These services are important to the businesses and to the people who work in them.

Proponents of tax concessions as a growth strategy point to cases like the Mercedes-Benz factory in Alabama, which now supports a few thousand jobs. Opponents mention that the state paid well over $150,000 for each of those jobs. Then they point to South Dakota, which is sort of like Minnesota without the high taxes, but also without the all the companies and all the jobs Minnesota has. Over the past few years, as the debate over these kinds of concessions has intensified, the number of studies reporting on the problem has multiplied. Now comes Robert Lynch, of the Economic Policy Institute, with a survey of several dozen such studies.

And well, the plot's a bit thin. He really has only one theme, but boy does he hammer on it. His point: that the services government provides are at least as important to economic growth as the taxes on business, and usually much more so. What he finds, in wading through the

In order left to right the figure shows the growth of the property tax, the income tax, sales tax, business taxes, and the total state budget. The big one to the right is the growth in the state economy. So how did you do?

econometric studies, the interview studies and the survey studies, is that there isn't really *any* persuasive data to make the case that tax concessions have a net positive benefit to growth. The only studies he finds that show evidence of a positive effect are a couple of econometric studies — Bartik is one prominent name — that implicitly assume that you can lower taxes without reducing spending on public services.

Low taxes are good for business, but public services are even better.

Timothy Bartik, an economist with the Upjohn Institute in Kalamazoo, Michigan, has published several technical papers on the subject of firm location decisions. In typical economist fashion, he applies sophisticated mathematical techniques to extract trends from the raw survey data. But also in typical economist fashion, he either doesn't realize, or hopes we won't notice, that his method is meant for teasing apart the importance of *independent* variables. Taxes and public services, for example, are not independent. Lowering one tends to lower the other. By treating the two as independent, Bartik's work is really asking whether it's good to lower taxes while keeping services constant. You don't need a degree in economics to see that (a) this is a good idea, and (b) this is usually impossible. In other words, Bartik's work is a nearly perfect example of highly sophisticated bad math.

In a similarly efficient fashion, Lynch disposes of the business-climate argument for tax concessions. What evidence, he asks, is there that a "signal" sent by a tax cut will be received by the population of businesses it's aimed at? Reviewing the literature, he concludes pretty much none, and if the tax concession is a small one, any conceptual effect will be swamped by the practical effect of much more significant costs. The sad truth: in the scale of expenses most businesses have, state taxes are pretty much peanuts when compared to rents, supplies, marketing, transportation, and even federal taxes.

Besides, "sending a signal" is a perverse way to sell a policy, especially when you're bankrupting the state in the process. Who gets the signal, and what do they think it is? The signal received might not be the one sent. We might mean to say, "We're pro-business here." But the signal received might be, "We're saps here. Take us for a ride." Stuff like this happens on dates all the time. (And it often starts with an ill-considered gift.)

Lynch moves on to systematically tackle pretty much all the arguments used to justify these concessions. Like toy ducks in a shooting gallery, he lines them up and bang, down they go. The business-climate argument, bang! The competitiveness argument, bang! The supply-side argument, the tax-burden argument and the demand-side argument, bang, bang, bang! Some of these canards are so tired and so often seen hanging around the state house that a citizen among those who pay for these concessions can hardly keep from cheering as they go down.

There are a couple of caveats throughout, where you can see that Rhode Island may be one of the places where the argument against incentives isn't as strong as in, say, Minnesota. We are quite small, as if anyone could forget it, and Massachusetts and Connecticut are quite convenient. But slightly more equivocal is hardly the same as overturning the argument, and his overall point is just as valid here as anywhere: the business of government is providing public services — safety, education, health — and the better and more efficient they are, the better for everyone, businesses and people, both. And when the services are threatened (see page 1), it's not at all good for either. ■

Rhode Island Policy Reporter
Box 23011
Providence, RI 02903

Come to the AS220 Stinktank forum on funding public education in RI! Friday, April 22, 5:30pm

stamp