Rhode Island Policy Reporter

Issue 15 **12 January 2006**

How much is too little? How little is too much?

EVERY YEAR THE CITIES AND TOWNS in our state complain that the state doesn't provide enough aid for their schools, and every year, the Governor and various members of the General Assembly complain that the towns are spendthrifts out to squander valuable state resources. It's the background noise of politics in Rhode Island. The state's share of public education has been shrinking for so long that towns treat it like the shortening days of winter: disappointing, but inevitable.

In 1993, the cities of Pawtucket, West Warwick and Woonsocket sued the state of Rhode Island, claiming that the state's method of funding public education was flawed and inequitable, since providing so much funding via the property tax favors the wealthier communities. The suit succeeded in Superior Court in 1994, but the following year it was struck down in the RI Supreme Court, who ruled that RI's funding system wasn't as inequitable as many other states, and that the equal-protection clause in the state constitution doesn't really cover schools, though it might if the inequities were larger. Which is to say that it was a fairly confusing decision in all but the "no" at the bottom.

In the late 1980's, under Governor DiPrete, the state had made a commitment to work toward funding 60% of all public education in the state. After the credit union crisis, under Governor Sundlun and his successors, the state steadily retreated until today most towns would be delighted to get back to 50%. At the same time, the legislature adjusted, trimmed, and then essentially scrapped the formula that had governed how state education aid was divided among the towns. So the situation now is that a town's allocation of state aid is essentially dependent on what it got last year. Amounts are adjusted up and down (mostly down) as state money is available (or not), but it's a fairly arbitrary process, and when programs like charter schools appear they claim a piece of the pie, making the share for public schools shrink still a bit more.

In an attempt to put paid to the whole debate once and for all, and to re-establish a set of rules governing how school aid is allocated, last year the RI General Assembly formed a commission[1] chaired jointly by Rep. Edie Ajello (D-Providence) and Sen. Hanna Gallo (D-Cranston), to consider the issue of what, after all, constitutes an "adequate" amount of money to spend on a child's public school education in Rhode Island. The committee convened in the spring. In the fall, they put out a request for proposals from consulting companies to provide a study of the subject. As of this writing, the situation is that the commission is waiting to award a contract for the study.

Press releases from the Assembly press office read this way:

> [The committee will] determine the cost of providing a basic education and recommend equitable, predictable and adequate methods of distributing education funding. The recently organized committee will study Rhode Island's student population, demographics, property tax rates, the costs of providing a basic education, and other states' distribution formulas.[2]

The first step in the proposed study is to come up with a number for how much it costs to give a child a "minimally adequate" education in Rhode Island in the 21st Century. The phrase refers, in a legal sense, to a 1973 US Supreme Court decision *San Antonio School Board v. Rodriguez* that held that—contrary to the 1954 *Brown v. Board of Education*—students in America are only entitled to that level of education. There is no (federal) right to equity in schools.

The proposed study is a good first step, but one hopes that the outcome will be more than a minimally adequate education for any of our children. Are art and music, for example, part of a minimally adequate program? History? Health? The proper contents of a public education is a deeply value-laden judgment. It's hard to see how an outside consultant could end such a debate. Still, the joint commission represents the first real step our government has made in years towards addressing the problems with how we fund our public schools. ■

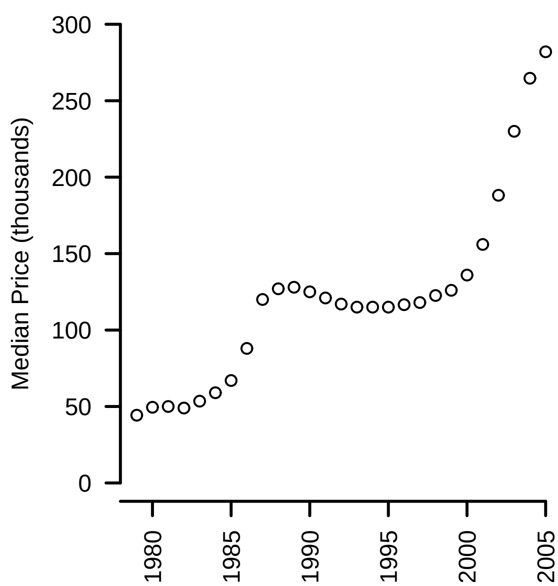

Figure 1: The median price of a single-family home in Rhode Island. See article. (Source: RI Association of Realtors)

Why does someone buy a house?

There are almost as many answers to this question as there are people, but there are two categories that hold many of the an-

[1] Officially the Joint Legislative Committee to Establish a Permanent Education Foundation Aid Formula.

[2] It is interesting that the committee regards its charge in an expansive fashion, and hopes to speak to issues beyond education spending such as how property taxes are levied and the proper balance between state and local funding. At the same time, a Permanent Joint Committee on Economic Development has been formed with chairs Rep. Betsy Dennigan (D-East Providence) and Sen. Walter Felag or other (D-East Bay), who also regards their charge expansively, hoping to take on the issue of property taxes, and the Governor is hiring for the new office of state Tax Policy Director, also to address the same issues.

swers. People buy houses to live in, and they buy houses as an investment, expecting to earn money by the appreciation in market value. And many people manage to do both at the same time. The demand for housing can be thought of as made up of these two components.

It's hard to look at the incredible run-up in housing prices Rhode Island has seen in the past few years without wondering where all this demand comes from.[3] Population grows smoothly and relatively slowly, but this price explosion certainly hasn't been smooth or slow (see figure 1).[4] Other explanations center on the historically low interest rates during this time. But again, the decline in real interest rates was a fairly slow process, whereas the sudden jump in real estate prices was not.

With this question in mind, we spent some time recently with the Federal Reserve Bank's most recent "Flow of Funds" data. This is a quarterly report with all kinds of aggregate data describing how our nation's money is invested and where it is spent. The graph to the right shows three trends from that report. The three lines each represent a component of household assets, expressed as a percentage of all houshold assets. The Real Estate line, for example, shows that about 25% of a household's assets were in real estate during the 1950's and 1960's.

The interesting thing about this graph is the mirror nature of the real estate and stock lines. One goes up when the other goes down. The real estate line seems to have a natural floor at around 23-25% of household assets (where it sat before 1970) but the distance above that floor seems to vary inversely with the amount of money in stocks: as money flows out of stocks, it appears to flow into real estate, and *vice versa*. Since 2000, real estate has expanded from 23% of total household assets to about 33%, while stocks have declined from 26% to about 16%.

Stocks and real estate are both important components of modern American financial planning, but they are different in one fundamental way. Real estate isn't just an investment, you can also live in it. The purchase of stocks, on the other hand, is rarely done for any reason other than for the investment returns.

Is it possible to separate the speculative investment in real estate from the purchase of housing? The apparent symmetry between real estate assets and stock market assets gives a clue to how that can be done. You can't be definitive on the topic with only this data, but you can put upper and lower bounds on the numbers. For example, you could argue, based only on the historical record shown in the figure, that any real estate investment above the 25% level is speculative, which would lead you to believe that in 2005, about a quarter of all household real estate investment is speculative.[5] This is a huge number.

On the other end, you could argue that only the changes not explained by the movement of prices is speculative. That is, the shift in asset composition might be simply because the price of the real estate homeowners already have has gone up, and the price of the stocks they held went down. Since 2000, the median house price (nationally) is up about 52%, and the stock market is down about 13% as of the third quarter of 2005.[6] Inserting these numbers into the mill shows that price movement alone can only explain about $\frac{2}{3}$ of the shift in household assets. This justifies an estimate that around ten percent of all house-

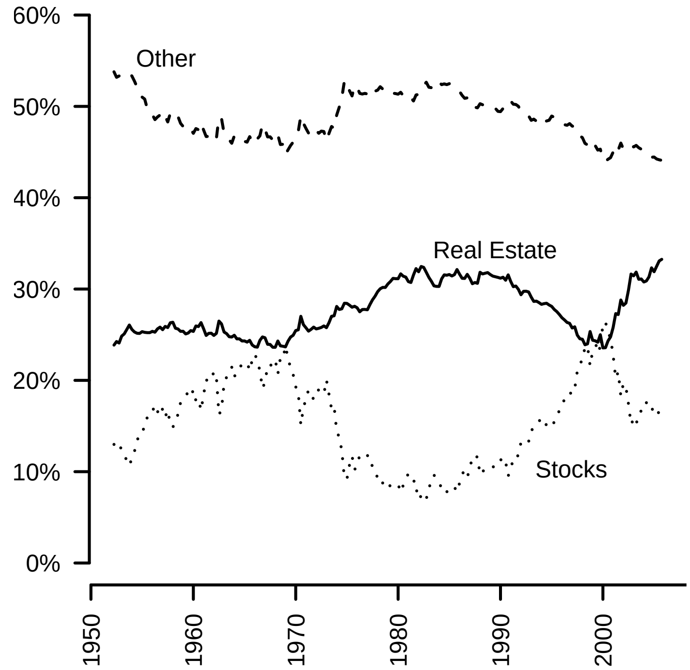

Figure 2: The proportion of household assets in different forms. "Stocks" includes mutual funds as well as direct ownership of stock. "Other" includes all financial assets that are not stocks, including bank accounts, bonds, life insurance and so on. You can see from the graph that over the last five years, the price appreciation in real estate is mirrored by the stocks line, without nearly as much movement in the "Other" line. Note: This is aggregate data, so it isn't going to look much like any single household's balance sheet. (Source: Federal Reserve Bank, Flow of Funds Report)

[3] And the boom is driven by demand, not increases in wages, permitting or construction costs. See **RIPR** issue 14, available at *whatcheer.net*.

[4] We're growing, but only slightly, according to the state Planning Department. See *planning.ri.gov/census/tp154.pdf*

[5] This is as good a place as any to remind you that the estimates here are all derived from measurements of household finances, so they have nothing to say about corporate ownership of residential real estate. Nationally, the value of all corporate real estate, commercial and residential, is less than a third the value of household-held real estate.

[6] Housing price changes are calculated from data in *US Housing Market Conditions*, a publication of the US Housing and Urban Development Department, November 2005. Stock market calculations are from Standard & Poor's index data.

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 ☙ *editor@whatcheer.net*
subscriptions: $35/11 issues, $20/6 issues
editor & author of unsigned articles: Tom Sgouros
Issue 15 ☙ 12 January 2006 (1.9)
published by the AS220 Stinktank Press

hold investment in residential real estate is essentially speculative. This is clearly an underestimate, since the movement of money into a market pushes up the prices in that market, but it will serve to put a conservative floor under our numbers.

So nationally, between 10% and 25% of all real estate investment is essentially investment that depends on capital appreciation.[7] Remember, this isn't the people who are buying a house to live in and thinking the house will also earn money for their children's college tuition or for retirement. They've been with us all along. This is investment that has quite recently supplanted speculation in the stock market.

And this investment isn't spread evenly across the country. You won't make a killing in Elmira, New York or Decatur, Illinois, according to the HUD statistics. But serious money can be made in the hot coastal markets—like Rhode Island—and it is likely that the proportion of speculation is substantially higher there. Within those markets, there are areas where you can readily find bargains, and one would expect the proportion to be even higher there. As an illustration, consider the case of Madeline Walker, the 81-year-old resident of South Providence whose house was lost over an $882 unpaid sewer bill. After her house was scooped up in a tax sale, it was resold twice more within only a few months. Both speculators got a bargain and pocketed a tremendous profit, at the expense of a poor woman who would have lost her home but for the intervention of the Governor's office (who intervened, secured legal help for her, and had the purchases nullified). Mrs. Walker's age and condition provided the public sympathy necessary to force people to act, but this kind of thing has been standard operating procedure in South Providence for years.

> *Real estate speculation works best where markets are hot <u>and</u> where you can get a bargain.*

In RI every year, about $4.5 billion of residential real estate is sold.[8] According to the estimates developed here, well over $450 million of that money—and possibly much more than a billion—is essentially speculative. That is, it's not being spent to provide housing for anybody, but only in order to make money for its owner. In the process it makes housing more expensive for the people who only want a place to live, and the effects are worst in precisely those places where the people need affordable housing the most.

Understanding the composition of housing demand in Rhode Island helps us see that the affordable housing crisis need not have been as bad as it is. Judicious use of disincentives to speculation could certainly have helped preserve neighborhoods by rinsing away a huge fraction of the demand. **RIPR** issue 14 contained a description of Vermont's anti-speculation tax on land capital gains. This tax hasn't stopped real estate from appreciating a lot in Vermont. But that state's own affordable housing crisis stems from the 67% increase in housing prices between 1996 and 2004.[9] During that same time, prices in Rhode Island appreciated 127%.

As of this writing, the housing market in Rhode Island is showing signs of cooling off. The graph in figure 1 shows signs that prices are peaking, and anecdotes from the real estate front seem to confirm this. But even in a more moderate market than we've had lately, it's still possible to make a ton of money by exploiting the less affluent parts of our state. That's where the bargains are, and that's where speculators do the most damage to the supply of affordable housing in the state. ■

INTERVIEW: THOM DELLER

Housing Policy in Providence

*While researching last issue's article about housing, criticisms of Providence's housing policy were easy to find. The official opposition to inclusionary zoning has advocates confused and the many high-profile high-end residences being built downtown contribute to a suspicion that affordable housing isn't high on Providence's agenda. With this in mind, **RIPR** sat down for a conversation with Thom Deller, Director of Planning for the City of Providence.*

RIPR: When I was researching a housing article the activists, I discovered that the people who are in the field and thinking hard about these issues were not aware of Providence's housing plan. All they were aware of is the opposition to what they think are sensible components of such a plan. So the obvious place to start is to ask you to outline the major components of what Providence is planning to do for affordable housing.

TD: The [City's Comprehensive] plan was done in '94 updated in '97 and again in 2002, when it was approved by the state, and there is a housing component in it. But we've always done our consolidated plan which is a requirement of the Federal government for the federal dollars that we get to lay out the types of housing needs, whether they be rental, homeowner, elderly, special needs, on and on. We have goals, five year goals that are laid out. That is developed by a public process, where we have a series of meetings. We just finished revising it, and that really laid out our goals.

RIPR: But the question isn't so much about goals, as about what you're going to *do*.

TD: So when I came back to the city in 2003, the Council had passed a tax stabilization deal for Rising Sun that required them to put money into a housing trust. No such thing existed, so they asked the redevelopment agency to create one. And working with the council directive, and the Mayor's staff, we decided

[7] This kind of flow of investment funds was encouraged by Congress in 1997, when they passed changes to tax law that make tremendous real estate capital gains tax-free so long as you live in the house for at least 2 years. This tax change made real estate you live in (or pretend to) about the most profitable kind of investment available to households.

[8] Data from the RI Association of Realtors. It's useful to compare these numbers to the $7.5 million that the state puts into affordable housing projects every year.

[9] Source: Vermont Housing Awareness Coalition. See their 2005 report: "Between a Rock and a Hard Place" at *housingawareness.org*.

to consolidate all the city's funding programs under the "Providence Housing Trust," and to make them programs that turn around: we loan money out and it comes back. So there's five different pots. And each pot has certain goals. The tax stabilization dollars are very small, only a little over $200,000, and now that we know how much we anticipate getting in that pot, we're going to be meeting with RI Housing to see if we can borrow money in anticipation so we can fund that pot and pay it off with tax stabilization dollars over the next ten years and then we're going to meet with community groups so we can define a program.

One of the things we want to do is hit the different populations that the federal program doesn't. Right now the federal dollars are eligible for people from 60% to 80% of median income. One of the biggest things when we try to turn neighborhoods around and try to create affordable housing is to help people in the 80% to 120% income bracket, who are first time home buyers but still can't afford to buy a house. But if we can help them get into a house that's a two-family and we can put restrictions on that second unit that says that it has to be rented to people at a lower income then we can start increasing the supply.

RIPR: Those are deed restrictions?

TD: Deed restrictions, they travel with the land. Whoever owns it would put requirements on the people. Then we get housing dollars every year from the federal government. Great program. We've been averaging about, working with the Community Development Corporations (CDC's), about 130 units of affordable housing a year. What we do is we put our dollars into deals where RI Housing has put dollars, where other groups have put dollars, and we end up producing both homeownership and rental housing. And it's a good program but it just doesn't get to the low income. Then we have the housing dollars that come in through the bond program that the city created in 1994, and put some additional money in it in 2000 that was the old Providence Neighborhood Housing Corporation dollars. Those dollars recycle. We loan money out, people sell their house it comes back. Those dollars are used for housing rehab, emergency repair, first time home-buyers' assistance, and so on. Then we have the lead pot, for houses with lead problems and we can help the people clean it up.

The biggest need is for people at 50%, and the city doesn't really have the money for it.

The frustration that we have is that the biggest need is housing for people at less than 50% [of median income] but yet we don't really have the money to address that issue. That has traditionally been a federal role and the federal government is pulling out of it and they've just withdrew a whole bunch of housing vouchers from the Providence Housing Authority so now we have less money to help people in that category and its getting harder and harder to look at creating an apartment unit that would be affordable to someone at the 30% level.

RIPR: All of the programs you outlined are essentially aimed at building new housing, with minor exceptions. But when I look at the statistics of housing and the growth in demand, it seems that most government attempts to deal with the problem by dealing with the supply are doomed to failure because the market forces are so huge. First, do you have data to disagree with that? Second, what can the city do that would address the market itself?

TD: You say you think they're doomed, but in what way? Because the market will drive up prices?

RIPR: Yes, but also because the real estate market in RI is about $5 billion a year between sales and rentals. Meanwhile, the grand total of what the state and federal government puts in is...

Compared to the size of the problem, the money available is... Peanuts

TD: Peanuts.

RIPR: ...not even up to a hundredth of that. And so programs whose only aim is to build our way out of the affordable housing problem are helping this particular family or that family, but they don't have the size to affect the market.

TD: 137 units a year is not a lot. And it's very difficult to outbuild the market. One of the other possibilities is to actually buy—one of the things we've talked about is actually start buying down the value of existing housing so that it's affordable to more people... We'll never make more than a minor dent in the affordable housing issue unless there's a major change in the market.

RIPR: Is there nothing that the city can do to affect the market?

TD: First we don't want to affect the market in a way that it stops the production of housing. One of the things that's killing us right now is that Providence is so affordable and so easy to get to Boston that most of our housing growth in the state and in the city has been out of staters either buying a new house or someone buying a second house. That's one of the things that has created a shortage for us. So that if we were to change the market in a way to restrict it, to force different approaches, and the market isn't strong enough, the fear that we have is that we'd basically stop the market and what that would do is to drive prices even higher and make it even worse. So part of the approach we've been taking is to allow the market to build different kinds of housing in the city so that we can have more housing built and hopefully offset the impact of everyone moving into the state and maybe drive some prices down... The Mayor has said it and I have said it: when we're convinced that the market is strong enough that regulations won't stop the market then we're going to start asking the developers— we're going to start requiring the developers—to do something for affordability.

RIPR: What would you think of as evidence of being strong enough?

TD: Right now, PolicyLink [a consulting firm] is doing analysis, and we're hoping to look shortly at their numbers to see what they think the construction market is and whether the market is strong enough. It's really a matter of understanding it. Every time someone comes in to talk to us about housing development and asks for more density or more height, we say we want affordable housing as part of it. But that's not a requirement, they say. No, but we want to know what you can do. Because if you want us to consider this we want to see what you can do. So we've had one developer come in, and he came in with his numbers, and they're his numbers but I got finance people to look at them, and people who know the market to look at them, and they feel they're pretty accurate, and we're getting eight units of affordable housing in this 80-unit project. Their argument is that they can't afford more than that because it cuts into the profit level that they need to get their loan to build the project. So that's one of our concerns in looking at making this mandatory.

At this point the market is strong, but we have to be sure that the market is strong enough. If we stop development then we lose the tax dollars that pay for education and things like that. Many of these condos downtown aren't really going to cost us much in terms of services. They're self-contained, there's not going to be any kids, and so that gives us a cash influx that helps us address the other issues of education, public works, parks. And so it's a balancing act, and we're going to watch it and continue to follow it. We're not convinced we need to adopt an ordinance as such after this. We're convinced we can issue an executive order, much like Boston, that we can start requiring things, and making people do things. And we are trying right now, with everyone who comes in, to get something out of them.

RIPR: Do you have an agenda for this legislative session?

TD: Our big issue right now is trying to get the state housing plan focused in a way that every community does its fair share and that people who live in the state have a choice whether to live in Providence or Warwick or Cranston or Westerly or Little Compton. We're going to work hard with the housing groups to get the bond issue up for next November for $75 million, housing we're debating whether we're going to ask again for the changes in tax sale law that we've been trying to get and we're asking for some changes in eminent domain law so that we can use the fact that it's a drug house as a blighted condition which would allow us to use eminent domain to take it, or if it's environmentally contaminated we don't have to prove blight, we can use that as a basis to take the property.

Right now the market is strong, but is it strong enough for regulation? We just don't know.

On a local level we're going to start doing tax incremental financing, instead of doing tax stabilizations, using the future of taxes to borrow money now. And our basic policy we've laid out is that every tax increment financed deal *has* to have an affordable housing piece in it and we're trying to frame a program right now. There's one tax incremental financing deal in front of the city council right now that has $5 million earmarked for an affordable housing fund. There's two other developers coming in asking for it and we'll be looking for additional sums of money so we can keep generating money to help get housing in here through this large scale development that's happening.

RIPR: One of the things that comes up in conversation with housing advocates is the shape that downtown is taking. What people see is a lot of real high end, and they don't see concessions to affordable housing being significant or obvious.

TD: If someone asks the city for something, they have to give something back. 110 Westminster has asked nothing from the city. The Westin has asked nothing from the city. So at this point the approach has been that if no one asks us for something, we will do what we can to try to cajole them into doing something, but we have no power to force them. And this gets back to where is that market right now and is it strong enough that we can do an inclusionary zoning rule or some sort of impact fee or transfer fee that we can legally do. And until we understand that we're strong enough to do that and still have these people pay taxes and come and develop, we're not going to do it. Those two developments alone are going to add $6 million in property taxes a year. So that money is going to come back to the city for us to do things and hopefully do more on education and do some affordable housing. We tried to get something out of them and they decided they didn't want to do anything.

It's interesting and something that a lot of people don't know, but over the last four years, 2700 permits for dwelling units have been pulled. Almost 20% of those have been affordable. And almost all of that is in the neighborhoods. The problem that we suffer is that someone does a 110 Westminster and builds a 500-foot tall building or the Westin and builds a 360-foot building people see that, the press covers it. The press doesn't cover the development that goes on in the neighborhoods. We've estimated that there's about $3 billion worth of projects going on in the city right now. $900 million of that is in downtown. The rest is in the neighborhoods. So people aren't

Celebrate

As of issue number 15, our first subscriptions are expiring. If you're one of the charter members of our rather-too-exclusive club, we hope that you have enjoyed the articles you've seen so far. Curiously, our example hasn't stimulated a raft of competitors, so this is still the only place around the state to find articles looking at the source of housing demand or the mathematical shortcomings of property revaluations. Whether these two subjects fascinate you or, um, not, the first is the reason why our state's housing policy is doomed to insignificance and the other is why property taxes will always be unfair (see issue 6, August 2004). If you think it's important that *someone* in Rhode Island care about this kind of thing, please subscribe (or renew your subscription): $35/11 issues, address on page 2, or pay online at *whatcheer.net*. And did we mention the new ISSN number? –TS recognizing it because it's not high-end. I was up in Charles St. and while I was over there and I was stunned at the number of new houses, $200,000, or $250,000 houses are being built throughout the north end, places that haven't seen housing for years. We have a housing boom going on in the city and people don't recognize it.

RIPR: But if all that stuff is happening, doesn't it imply that there's energy enough to siphon off some to serve the low end that's not being served?

TD: Well that's what we're trying to figure out. Would a 110 Westminster have come if they had to pay a fee of $100,000 a unit to buy out of the affordability. Let's say it was a 20% and they have about 100 units. Would they have paid us $2 million and would the project still work?

RIPR: Do you know what the construction costs for 110 Westminster are?

TD: I haven't seen the newest numbers. The last number I saw was $95 million.

RIPR: And $2 million more is an impossible obstacle?

TD: That's the question. One of the things that's happened in Boston now is that developers are leaving because of the inclusionary zoning the city is enforcing. I think they're collecting $165,000 a unit right now.

RIPR: And the process for finding out is the consultant?

TD: Yes, PolicyLink is doing that. They will be throwing numbers back at us and what we're going to do is to take those numbers to the non-profits and to some for-profit developers that we've worked with and have them analyze them. The first set of numbers that I saw from PolicyLink about a month ago, they were assuming they could buy land in downtown Providence for $50/foot, they were assuming they could do surface parking to meet all their parking criteria and those are things you can't do in downtown. First off, land downtown is about $130/foot, not $50, so there was a huge error in their calculations right off the bat. But if we are convinced that the numbers work, the Mayor's ready to slap in an executive order requiring it. I've said this to PolicyLink and others, I'm hesitant to make a provision in the zoning ordinance that is a law because then to change it takes time and we could force ourselves out of the market. We could do more damage by having the new ordinance cause a downturn and show it isn't working, and by the time we got the law changed we could lose a whole cycle, and Providence is notorious for missing development cycles.

RIPR: There are other ways to preserve affordable housing that I know are in use in other parts of the state. Community land trusts.[10]

TD: We are working with groups to create a land trust. It's something we think makes sense. I will tell you there are a lot of people on the City Council who don't like that concept. The response I got from one councilwoman was, "What good does it do if I don't own the land?"

RIPR: Do you talk about rent control?

TD: We do not. It's something that would have to be a state thing. But I think before we could do that, and convince the legislature to pass it, we'd have to have a very clear market analysis that shows it would work. And I think that if they were to pass enabling legislation it would be a bigger issue than just Providence. It would be Central Falls and Woonsocket and everywhere else and I think this is one of those issues I'd like to see the state try to lead on and get the analysis done.

RIPR: Final question: So the city is able by hook and by crook to come up with the money to do 137 units of housing every year. How much difference does that make?

TD: Negligible. But for the people who get those houses it makes a lot of difference. If these programs weren't happening, they wouldn't have a place that's modern and where the heat works. So any difference, no matter how negligible it is is important for the people who are going to benefit by it. ■

[10] This is a form of land trust where you own your house, but it's on land owned by the trust. You have a 99-year lease from the trust, but they usually have some kind of affordability requirements, such as a limit on the amount of money you can make by reselling the house.

Rhode Island Policy Reporter
Box 23011
Providence, RI 02903

stamp