Rhode Island Policy Reporter

Issue 19 **21 June 2006**

"We" the people

ONE OF THE AMUSEMENTS available to researchers browsing through our state's law books is the occasional glimpse of a particular person for whom some law was passed. Charles Trumpetto, for example, who served as Chief Judge of the District Court until 1987, was granted a special free license plate for life, and the fact is immortalized in our laws, chapter 31, section 3-49.[1] Sometimes the law doesn't mention the name of the favored citizen. Over in the Courts chapter, there's §8-4-4.1 establishing the office of clerk emeritus for whoever had been clerk for nine years on May 16, 1984, so he could perform marriages.

These examples are funny: exasperating but mostly harmless exercises of the legislature's power. They perpetuate the idea that Rhode Islanders with access have special privilege, but the privilege isn't really that special, so it's hard to get too exercised about them. Less innocuous are the special tax breaks for corporate taxpayers, like the American Power Conversion tax cuts of the early 1990's (§44-43-8) or the Providence Mall sales tax deal, enshrined in §42-63.5-2, where it really does read "Providence Place Mall." Beyond the amusement, these finds make it clear that what we're taught in grade school about laws and the legislature aren't the whole story.

Theorists of government fall more or less into one of two schools of thought. One says that the laws and customs of our government are a recording of the collective wisdom of our electorate; the rules we have agreed to live by, "in order to form a more perfect union." You could call it the Jeffersonian school, though Jean-Jacques Rousseau's "Social Contract" should also be held responsible. Another school—say that of Marx or Machiavelli—is simply that these documents and customs are just a part of the apparatus by which those in power remain in power. According to this interpretation, the fine theories of the other view are simply the window dressing without which most of us simply would not go along with government.

Sadly, the 21st Century has made it abundantly clear, even to casual observers, that the happy Jeffersonian view is hard to reconcile with the daily newspaper. The news is littered with examples of laws whose benefit is to the few, not the many. Congress and the President conspire to give us a Medicare drug benefit that mostly benefits drug companies and to make appalling special deals for a select few defense contractors. Federal antitrust enforcement is little more than a fond memory. And now, the nation's handful of large telecommunication companies are seeking to overturn FCC regulations so they can charge twice for the same internet traffic.[2] These laws do not reflect Jeffersonian ideals, but more like something

[1] Several others are so honored in that section, including an ex-sheriff of Kent County, a couple of former town police and fire chiefs (Woonsocket, Johnston), and only two of our several ex-Congressional representatives.

[2] This is the debate over "net neutrality" a doctrine that rules the telephone industry, but the telecommunication companies want it overturned for the internet. Passed by the House, the Senate debates it soon.

The Shape of the Starting Line

On Flag Day, June 14, Working RI, in association with the NEA/RI and RIFTHP, the two teacher unions, published an extensive policy review about education, written by me. The paper, called "The Shape of the Starting Line," reviews the research literature on the relation between children's academic success and poverty, nutrition, school environments, early childhood education and more, demonstrating why, for many kids entering kindergarten, the starting line just isn't straight. The paper also puts some of the discussion about school costs in perspective, using research first published in these pages.

The research for the paper was endlessly fascinating, and could have been endless, too. The result only represents a small fraction of what's available. In the coming months, some of that material may find its way here, but in the meantime, you can get a copy of the paper at *whatcheer.net* or *rifthp.org*.

The paper does present quite a long list of things we could be doing to make our schools better, especially for the children of our cities. They will cost money. To paraphrase Robert Kennedy (who was paraphrasing George Bernard Shaw): "You see things; and you say, 'Why?' But some people dream things that never were and ask, 'How much?"' Some will doubtless say that if this is what we need to do, it's far too expensive. But I reply that we are currently wasting a tremendous amount of human capital: children who grow up into futures that have no opportunity in them. Can we afford to save them? We can't afford not to. –TS from Marx (or Lenin). That they are largely the result of Republican control of the federal government is an irony that dwarfs my ability to conjure a metaphor.

In Rhode Island, we regularly see special deals for any large company who threatens to move into or out of the state. Rhode Island recently lost a bidding war with Massachusetts over a new factory planned by Bristol-Myers Squibb. Governor Carcieri candidly admitted that we were simply outbid. Massachusetts reportedly offered tax cuts and incentives worth over $60 million.[3]

But the modern world is a world of growth and speed, so it should hardly seem surprising that this trend, too, is accelerating. Now it seems Rhode Island will get a chance to vote not just about changing laws for the benefit of specific corporations and people, but changing the state constitution to make a few citizens very wealthy.

It's not as if the state constitution, rewritten by a convention in 1986, is a thing of poetry. It borrows what grandness it has, like the quote from George Washington's farewell address in Article I:

> "...the basis of our political systems is the right of the people to make and alter their constitutions of government; but that the constitution which at any time exists, till changed by an explicit and authentic act of the whole people, is sacredly obligatory upon all."

A vote to approve the casino amendment this fall will give the Narragansett Indians and Harrah's an exclusive "right" to run a casino in West Warwick, a right to be "sacredly obligatory" on all of us, right there next to the rights like the right to a speedy trial and that "all laws should be made for the good of the whole." Even ignoring the well-documented increases in burglaries and DUI's associated with casinos[4] and even if you think that a casino is a net addition to the state's economy,[5] this is a strange thing to do to our Constitution. Despite its committee-of-lawyers tone, this is supposed to be the document where we record the common principles of government on which we can all agree. Like breaking wind during the quiet reaches of a string quartet, an amendment to the state constitution specifically to guarantee a no-bid contract for Harrah's and the Narragansetts is an ugly thing that just doesn't belong there. Not only is this an unmusical kind of amendment; think of the smell. ■

[3]This for a factory expected to employ about 550 people. In other words, about $90,000 per job.

[4]See, for example, a study from the Wisconsin Policy Research Institute that documented a 13% increase in burglaries in counties that established casinos: *www.wpri.org/Reports/Volume9/Vol9no9.pdf*.

[5]The evidence is mixed. A University of New Orleans study found some basically positive results in Louisiana, but they rely on readily measurable data and the study's authors pointed out that many effects of a casino are not easily measurable: *www.business.uno.edu/dber/gambling1998/EconR.pdf*.

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What's really going on, instead of what's said about it.
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Do tax cuts shrink government?

A forthcoming article by William Niskanen, the director of the libertarian Cato Institute, reviews the idea that cutting taxes is a sensible step in reducing the size of government. [6] The theory, sometimes referred to as the "Starve the Beast" strategy, is the intellectual foundation of today's Republican party, and it's so much a part of mainstream political discourse that no one remembers a time when this kind of talk would have been thought rather odd. Back then, in order to cut a budget, you had to suggest something to cut. The idea that you could be *for* something as amorphous and content-free as simply paying less for government simply wasn't the done thing. You can see this in the data. In the graph on page 2,

[6]I'm indebted to an article in the June 2006 Atlantic Monthly for bringing Mr. Niskanen's work to my attention. Mr. Niskanen was kind enough to share a pre-publication draft of his work, and the analysis here is drawn from that.

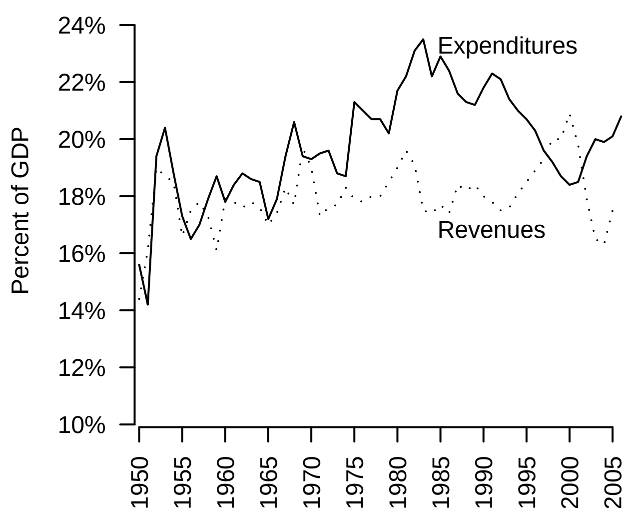

Figure 1: The dotted line is federal government outlays as a percent of GDP, and the solid line is revenues. Postwar, the two tracked fairly closely until 1970 (and a bit further, if you discount the effects of the unemployment rate and interest rate on federal spending). Since then—strange as it sounds—spending declines when taxes are rising and vice versa. (Source: Economic Report of the President)

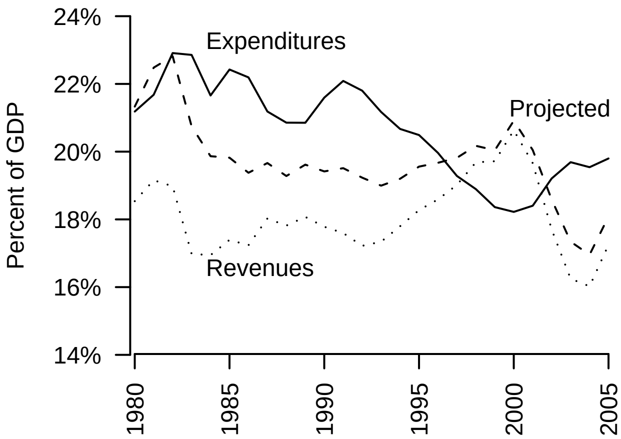

Figure 2: A close-up of the last 25 years. The dashed line labeled "Projected" shows what Presidents before Reagan might have done with the revenue we received. Of course they'd have done everything else differently, too, so this is just for illustration.

government revenues and expenses move more or less together until the 1970's. After that, they don't.

Niskanen's article attacks the theory first: according to orthodox price economics, price controls are a bad thing because when you artifically lower the price of something, people demand more than they would otherwise. Running deficits is something akin to artifically lowering the price of government, so according to this theory, people will ask for more government, not less. Niskanen expresses some surprise that such advocates of price theory as economist Milton Friedman would endorse Starve the Beast as late as 2003.

Why is that late? Because it was almost 30 years ago that some people began to promote the idea that one could be thought intellectually respectable while proposing to cut taxes without suggesting what spending to cut. Instead of shrinking government by cutting programs, the idea was simply to shrink it by cutting taxes, and letting the pressure of tight budgets do the job for you. The tax revolts in California and Massachusetts were just such campaigns. Neither campaign was really based on a critique of what government did, just how much it cost, and leaders in both campaigns spoke in generalities about "doing more with less" and "creating efficiency" that allowed any listener to imagine that the services they valued would continue to be provided (often falsely). Neither campaign dealt with the inconvenient details, but both were highly successful, and Ronald Reagan took note, and so did the people who crafted his budgets.

It wasn't until the late 1970's that cutting taxes without cutting programs became a respectable suggestion.

For better or worse, the date of this revolution means that we now have a quarter century of actual budget data. We can answer the questions in terms of practice, not just theory. So does it work? In a nutshell: no. Niskanen did some statistical analyses of these numbers which allowed him to correct for the outside effects of the interest rates and the unemployment rate, which both have an effect on the federal budget independent of government policy. Even after these corrections, the answer is still no.

A surprise was hiding in the details. Not only doesn't it work to starve the beast, but after controlling for changes in unemployment and interest rates, it seems that the relation between federal revenues and expenditure growth since Reagan is actually *negative*. Since 1980, as taxes have fallen, spending has risen, and when taxes have risen, spending has fallen. This sounds very odd, but it's true. Reagan and the Bushes have given us bigger government with higher deficits, and Clinton gave us smaller government with a surplus. To be fair, this is an over-simple analysis, concentrating on gross measures, like total federal spending, which don't reflect some important detail. But when the theoretical analysis is backed up with the practical record, it becomes a compelling argument, even from this kind of bird's-eye view.

Since 1980, when taxes have fallen, spending has risen, and vice versa.

Niskanen's analysis is about the relation between expenditure *growth* and taxes, but you can see a similar story in the simple relation between expenditure and revenue, which is also negative since 1980, after discounting unemployment and interest rates. With this measure, I found several long periods with significant positive correlations before 1980,[7] but remarkably, I found no other period after 1901 with a significant negative relationship—not during the Great Depression, nor during the World Wars, nor during the Cold War—none. In other words, before Reagan, there was wide agreement about how to handle government finances. Certainly the government ran deficits, but in general, revenues and expenses traveled in the same direction. When spending went up, taxes went up to pay for it, though perhaps not as fast. When revenue went down, spending was cut, though perhaps not as fast.

Figure 2 illustrates the sea change. The solid line shows federal spending as a percentage of GDP from 1980 to

[7] Budget data for this analysis came from the Economic Report of the President. GDP and interest rates are from the Economic History web site (*eh.net*), and articles there by Lawrence Officer, "What Was the Interest Rate Then" (2003) and Louis D. Johnston and Samuel H. Williamson, "The Annual Real and Nominal GDP for the United States, 1790–Present" (2005). The historic unemployment rates are from the Bureau of Labor Statistics, back to 1929. Before that, unemployment did not have much effect on the federal budget, since there were so few federal social insurance programs.

2005, and the dotted line shows revenue, just as in figure 1. The new dashed line shows what federal spending would have been if the presidents since 1980 had conformed to the postwar norms until then. You can see that where a president like Eisenhower would have lowered federal spending by a lot in the 1980's, it didn't decline nearly as fast under Reagan or Bush Sr. Where Kennedy might have increased spending in the 1990's to take advantage of rising revenues, Clinton cut spending dramatically to lower the deficit. It seems that what is now thought to be good electoral strategy really was once upon a time widely thought to be too cynical to use. Niskanen's analysis shows us that Eisenhower didn't govern this way, Truman didn't, and neither, apparently, did Kennedy, or Johnson or any other 20th century president. "Cynical" is a character trait once thought to define Richard Nixon, but his "secret plan" was about the war, not taxes.

The analysis also shows us that "Starve the Beast" isn't just questionable theory and a disingenuous lack of specifics. The data tell the story: with a quarter-century's experience, we can say that there is a fundamental dishonesty associated with campaigns that promise to "cut taxes" but won't tell us what programs are to go in order to pay for the cuts. Campaigns as simple as this promise what they can't deliver, and the candidates who get elected this way deliver the opposite of what they promise. The result is government bankrupted and unable to perform well even the uncontroversial functions.

This isn't only a national phenomenon. Rhode Island can't run a deficit in the current fiscal year, but we can run a deficit *next* year, which isn't a problem until then, and state government does that all the time. The recently passed 2007 budget does exactly this, via a huge tax cut for the 2,000 wealthiest Rhode Islanders that won't have its full impact until 2011. Inappropriate borrowing, like at the Department of Transportation, contributes, too.

No president before 1980 governed this way, not even in WWII or in the Great Depression.

Using tricks like these, Rhode Island governors are free to be as fiscally irresponsible as any president, and they and the Assembly have made the most of it, constantly promising lower taxes. And when they propose a program cut, and it fails or is modified in the legislature, somehow the taxes get cut anyway. This year is a perfect example, where the tax cut for the rich will cost $7.5 million next year, but ten times that in five years. Needless to say, no corresponding program cuts were made; that's a problem for legislators in 2010.

Our experience shows us that promising lower taxes without being specific is both ineffective at achieving the stated goals and very effective at getting candidates elected. But airy promises to lower taxes can only be an effective campaign strategy when people think the candidate making the promises is serious. When Ronald Reagan ran for president, people took him seriously. The press wrote respectfully about him, and Republican party activists and writers supported him and lacerated those who tried to call attention to the non-serious aspects of his platform (like George Bush, Sr., who memorably called Reagan's economic analysis "voodoo economics"). But the truth is that according to Niskanen's analysis, in fiscal matters Reagan was spouting nonsense. That he—along with successive candidates for president and state offices around the country—was allowed by the press and the public to masquerade as a serious candidate is to our lasting detriment.

When Reagan ran for office, people took him seriously. Perhaps this was a mistake. But whose was it?

It's a complex world, and it's no surprise that people rely on the opinions of others to form their own. But this reliance becomes our undoing when we allow serious-but-unconventional ideas to be mocked and the non-serious to be treated as wisdom. We rely on the press to tell us who's serious, while defenders of the media's objectivity say the press relies on the activists and voters. (US Senate candidate Carl Sheeler, along with a legion of third-party candidates, might beg to differ.) Be that as it may, we're now in a strange spot, where the irresponsible campaigners are rewarded with the reins of government. Whatever the responsibility for getting us here, at least remember the judgment of the director of one of the Republican party's favorite think tanks: according to theory and experience both, if what you want is smaller government, simply cutting taxes is a lousy way to get there. If you aren't brave enough to be specific about cuts, then go home and don't make things worse. ■

Who preserves historic housing?

MIKE LOZANO

Consider the following scenario: a heavily urban state is faced with thousands of decaying buildings and fallow industrial areas, commercial corridors, and residential neighborhoods as once prosperous manufacturing concerns continue their migration to other parts of the country and overseas. The buildings left behind are utilitarian and grand, full of craft and detail, but in a state of disrepair that will cost serious money to rehabilitate and pre-

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serve. State legislators, recognizing that something must be done, wisely enact a tax credit to help defray some of the costs to rehabilitate these historic buildings and encourage reuse and redevelopment over easier "greenfield" development. The tax credit proves wildly successful, with hundreds of buildings saved from the wrecking ball, thousands of housing units created, countless jobs created, and a massive increase in tax revenues.

If presented with this story, what would you do? A rational person might expand the program, building on its success. If you are the Rhode Island General Assembly, you look to gut the program to balance an unfortunate budget deficit. One of the leading reasons legislators use to justify their reasoning for abolishing or drastically reducing the tax credit is that it is being used to line the already-deep pockets of developers. However, the statistics tell a different story. The State Historic Preservation Tax Credit has enabled the creation of 409 affordable housing units, revitalized long-disinvested communities, and produced immense environmental savings through the reuse of existing building stock.

The Historic Tax Credit is one of RI's most effective affordable housing programs. Why mess with it?

How the tax credit works The tax credit works fairly simply—for every dollar spent rehabilitating an historic building, the developer gets 30¢ back as a credit on their income tax for that year. So if you spent $1,000,000 dollars rehabbing a vacant mill in Olneyville, you would get a $300,000 rebate on your state income tax, which can be taken over several years. The tax credit can also be sold to an investor, and non-profit developers can assign their credits to a for-profit partner for their use. This is an important provision—by selling the tax credit, a developer can use the tax credit as equity in their financing structure to greatly enhance the feasibility of these types of projects. As the number of projects using historic tax credits has increased, an entire secondary market has emerged, with brokers now specializing in these credits working to match up developers with private investors, and a whole network of both individuals and corporations looking to buy credits to offset some of their state tax obligation. The broker or investor then pays a set price for the credit, currently about $.82 cents for every dollar of credit, and then uses that credit to offset their income tax. By doing this, an investor gets a return on their investment based on the spread of the investment against the credit, or in this case, 18%.

Who uses it? While large for-profit developers like Streuver Brothers, Eccles, and Rouse and Cornish Associates get lots of press for their high-priced mill and loft projects, several non-profit community development corporations (CDCs) are also using the credits to build the vast majority of affordable housing in the state and revitalizing and injecting capital into long disinvested communities. For these organizations, the state tax credit is an indispensable source of funding for very difficult to finance projects. Greater Elmwood Neighborhood Services (GENS), a CDC based in the Elmwood section of South Providence, has used this credit on several projects that could not have been completed without it. These include:

27 Whitmarsh Street This house is one of the oldest buildings in South Providence and was transformed from a vacant and dangerous neighborhood nuisance into a safe, comfortable, owner-occupied home with two affordable rental units.

Adelaide Avenue This project transformed the former

Where do the credits go?

The tax credit clearly offers an attractive return, and explains why the credit is so popular—it is quite effective at generating economic activity on both sides of the coin. In another instance of fuzzy logic in the Rhode Island State Legislature, there is mounting support for bills to right Rhode Island's supposed "anti-business" tax climate with proposals to cut the income tax for the very top income earners. The argument is that Rhode Island's tax structure is not competitive with those of Massachusetts and Connecticut, and driving highly paid corporate executives and their companies elsewhere. But is this really the case? Looking at where the historic tax credit goes shows that it is not.

The wealthiest income earners have the best and highest paid attorneys and accountants to find ways to bring their tax liability down, and the tax credit is one of the ways they accomplish this. It is perfectly legal, and in fact the system is built to encourage them to do so in order to generate economic benefit in ways that otherwise wouldn't happen on its own—restoring historic buildings, for example. But as credits and deductions are factored in, the real tax burden of these people is much lower than the base tax rates, and tax-lowering proponents, would indicate. To lower this rate would be a double bonus, and bring their real tax burden to ludicrously low levels completely at odds with a progressive tax system. This is why the current effort to lower the top income tax rate is so shortsighted—as is often the case, the legislature is merely looking at the face of the issue, and not adequately examining the real impact of what they are proposing.

Ironically, a cut in the tax rate for wealthy individuals may make the Historic Tax Credits less valuable, lowering the price the credits fetch through brokers. This would decrease the amount of money that goes into the building of a historic project, and increase the amount cut from the tax bills of the wealthy who buy the credits. –ML

Melrose Apartments, a dilapidated public housing project consisting of formerly magnificent Victorian era houses on Adelaide Avenue in Elmwood, into safe, healthy, and beautiful affordable housing for 47 families, including five first-time homeowners. The funding for the project came from many sources, including a HUD grant, HOME funds from the City of Providence, the State Neighborhood Opportunities Program, Low Income Housing Tax Credits, as well as federal and state historic tax credits.

Parkis/North Elmwood This project consists of four buildings and three vacant lots scattered along both sides of Parkis Avenue, one of Elmwood's most handsome, intact, and cohesive late 19th residential streets, near Grace Church Cemetery. The project, a mix of restoration and renovation and new historically sensistive construction, consists of 58 units of new family housing consisting of a mix ranging from studio and one-bedroom units, to larger two-, three-, and four- bedroom units.

Looking a little more carefully at one of these projects, the historic tax credit is a significant piece of the financing structure for the first phase of the Parkis/North Elmwood Project. The overall budget for the project is $4.4 million dollars. This includes acquisition of the property, construction costs, fees for architects, legal, and engineering, and other associated project costs. Of this amount, approximately $2.75 million dollars of the costs are eligible for the tax credit—items like the cost to acquire the land and buildings are not eligible. The total tax credit is 30% of this, or $825,000. These tax credits will then be sold to a broker, who will in turn sell them to individual and institutional investors. The broker commits to buy the credits at $.80 cents on the dollar—he will then sell them to the investors at $.82 cents on the dollar. The investors then save 18% on their taxes for the amount of the credits that they buy. GENS receives about $650,000 in equity for the project. Because the tax credits are only granted after the project is successfully completed and the building is placed in service, a bridge loan coupled with the construction financing is set up to bring that money into the project at the beginning to fund the actual construction.

Affordable Housing on the Air

A panel of experts takes on affordable housing for the next LaborVision show, seen on cable Interconnect B (ch. 14). The panel included Eric Hirsch of the Coalition for the Homeless, Brenda Clement of the Housing Network, the Rev. Matthew Kai from the RI Minister's Alliance, and the editor of this august journal. The show airs Tuesday, June 27, 7-8pm, Thursday, June 29 and July 6, 8-9pm and Saturday, July 1 and 8, 5-6pm. Come see. –TS

What is the credit's real cost? The State Historic Preservation Tax Credit is an important economic generator for the state, and an important part of the states overall tax system, income tax included. As the projects discussed illustrate, the State Historic Preservation Tax Credit is not just being used by greedy developers. It is one of the prime tools currently available to construct affordable housing and helps improve the lives of not just the lucky people who get to live in these fantastic buildings full of historic character, but also the neighbors and people who live and work near these structures that would otherwise stand rotting and generating crime and safety hazards. In a state that is woefully behind its neighbors in providing other subsidy sources for affordable housing, the historic tax credit is even more important. For a legislature who is considering gutting the program because of its "cost," it is vitally important that the true costs to the future of the state are factored in. ■

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