Rhode Island Policy Reporter

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Half a budget. Better than none?

BUDGET SEASON is upon us again. As is usual in recent years, there isn't very much to be cheery about, except for the crocuses coming up through the mud. Deep cuts are expected nearly everywhere in state and local government. But there is a faint silvery lining to the fiscal clouds this year. The size of the fiscal shortfall is so dramatic that it is forcing the people in charge to be honest about the issues, for the first time in years.

Our state is in a terrible fiscal situation this year: revenues won't meet expenditures for the *current* fiscal year, and they are even worse next year and the year after. A great deal of the blame for this situation can be laid at the feet of the people who crafted our state's budget in recent years. Last spring's budget proceedings were a model of either self-deception or double-talk by all parties (some of which was outlined in **RIPR** issue 22), and a measure of the deception is the size of the current year deficit: $100 million. The shenanigans did their job, and all the interested parties were re-elected last fall.

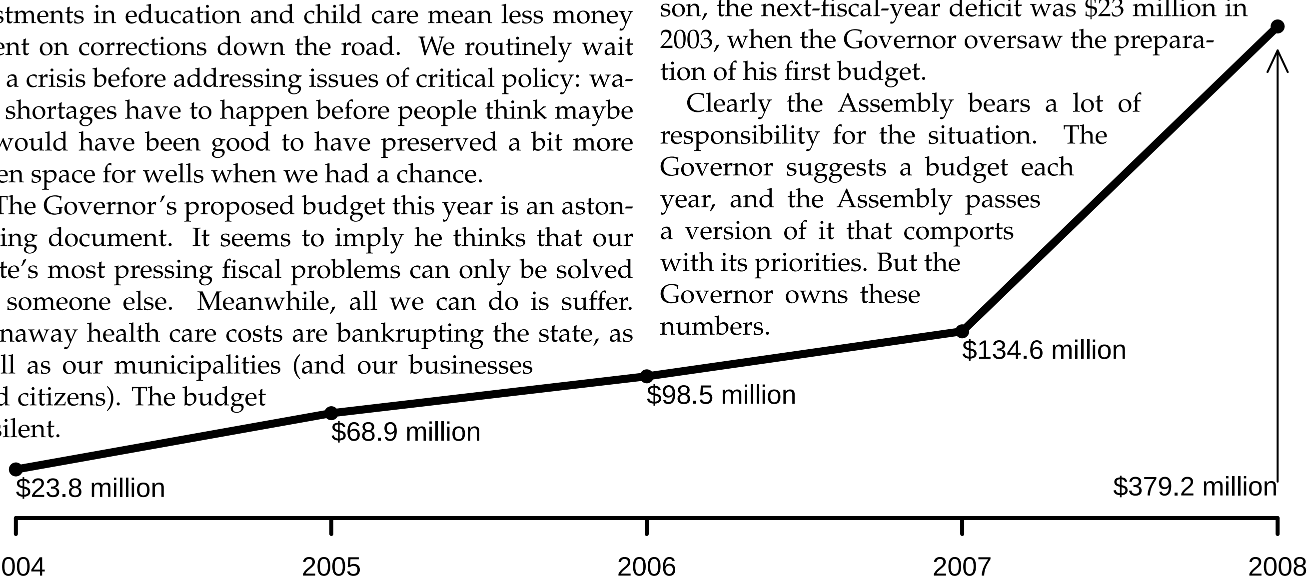
The issue is a simple refusal to add up the costs and present the taxpayers with the bill. For fear that people will be unhappy about the cost of providing government services, legislators and governors resort to tricks to put off or hide costs, which ultimately makes the services much more expensive. We routinely borrow for things that ought to be paid for out of current expenditures: the Department of Transportation is the model here, where we borrow tens of millions of dollars every year, come rain or shine. We routinely refuse to invest in places where we know we could save money in the future: investments in education and child care mean less money spent on corrections down the road. We routinely wait for a crisis before addressing issues of critical policy: water shortages have to happen before people think maybe it would have been good to have preserved a bit more open space for wells when we had a chance.

The Governor's proposed budget this year is an astonishing document. It seems to imply he thinks that our state's most pressing fiscal problems can only be solved by someone else. Meanwhile, all we can do is suffer. Runaway health care costs are bankrupting the state, as well as our municipalities (and our businesses and citizens). The budget is silent. The high costs of dealing with the unfunded liabilities of our pension system is a close second place in its effect both on state departments and cities and towns. Again, the budget is silent on the topic. What about the sorry state of municipal finance and education funding? No word. The escalating level of state debt? Nothing.

The "structural deficit" (what we call the deficit next year and after) gets a mention, and even some rhetorical flourishes. For example, the first page of the executive summary has a headline that reads "FY 2008 Budget Continues the Drive to Resolve the Structural Deficit." Unfortunately, the numbers from the budget's own executive summary (shown in the graph below) show that the claim is utterly withouth merit. In other words, of the several biggest fiscal problems facing our state, this budget addresses none of them.

Structural deficit The most extraordinary number in the FY08 budget is the estimate for the deficit *next* fiscal year: $379.2 million in 2009. The state is constitutionally required to balance its budget each year, but there's no requirement to balance it for the next year. We can often get through a year by selling some land, or finding some other source of one-time income, or by accounting changes. But the size of the next-year's deficit is a measurement of how honest we've been. A budget balanced honestly will have a low projected deficit the next year. What $379.2 million means is that our Governor is willingly and knowingly leading us to an even greater disaster than the one we're facing this year. Just for comparison, the next-fiscal-year deficit was $23 million in 2003, when the Governor oversaw the preparation of his first budget.

Clearly the Assembly bears a lot of responsibility for the situation. The Governor suggests a budget each year, and the Assembly passes a version of it that comports with its priorities. But the Governor owns these numbers.

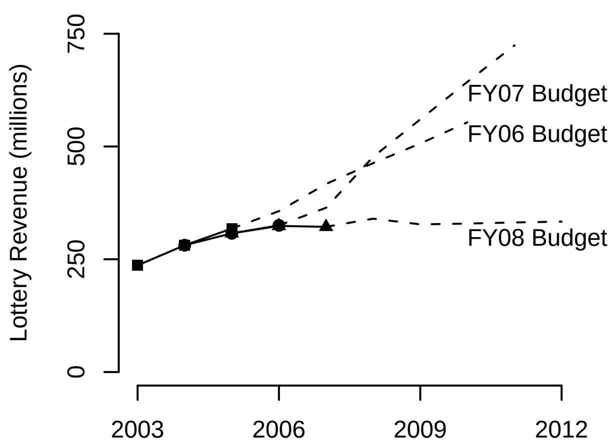


The "structural deficit." The graph above shows what Governor Carcieri's budget office thought the deficit would be the following year, in each of the budgets submitted since he took office. For the 2004 budget, this is the deficit that was anticipated for 2005. For 2008 (the budget under discussion now), it's the anticipated deficit in 2009. Each year has been worse than the year before, by a lot. But little of the underlying reality has changed. What these numbers mean is that our Governor knows that he is leading us to an even greater disaster than the one we're facing this year, and he hasn't figured out what to do about it.

This is his own budget office's predictions of our fiscal situation in the next year, *if the budget is enacted as he suggests*. What we see is that for each year of his administration, the Governor has looked ahead, seen things getting worse than they are this year, and declined to act to stop them.

Betting the farm There is a standout number in the future projections for the budget, and it's the projections of lottery revenue. (This includes both lottery ticket sales and revenue from the video terminals at Lincoln Park and Newport Grand.) News reports about the deficit have already said that lottery revenues are not up to last year's projections, but this isn't even half the story.

The picture below shows the lottery revenues, as presented in the budget documents for the last fiscal year, the present year and the next year. The first three points of each line are real data (though the third is only partial). The rest is just guesswork. Now educated guesswork is what a budget *is*, so there's nothing wrong with that, but let's look closely at the three lines.



As of 2005, when the 2006 budget was being put together, lottery revenues had been rising $25-30 million every year for the previous five years. Looking into what was then the future, budget forecasters apparently saw no reason that lottery revenue growth would decline, so they simply predicted that the growth would continue over the next five years. In the trade, this is called wildly optimistic, but it has data to back it up, so is almost excusable.

In 2006, though, it was apparent that lottery revenues were leveling off. The 2005 revenues came in $11 million short of the predictions, and the growth in the previous three years was 18.9%, 9.4% and 5.7%. So what did the budget office do? They predicted 12% growth in 2007 and *31%* growth in 2008. This is well past "wildly optimistic," and into the realm of outright delusional.

Trying to divine motives is the domain of mindreaders, not data nerds, but it is reasonable to point out the number of ways in which these outrageous predictions served the needs of people in power. Most obviously, Governor Carcieri needed a balanced budget without lots of controversial cuts in order to be re-elected. He got it, and won re-election by a nose. After that, House Speaker Murphy was pushing a plan to cut the taxes of the wealthiest Rhode Islanders. Having a budget appear to be headed for deep deficit would not have helped enact a plan that will cost us more than $100 million (see page 4).[1] He got what he needed, and the tax cut passed. Murphy's team may have also counted on the passage of the Narragansett Indian casino to shore up the lottery revenues.

In 2007, it has become abundantly clear that the lottery revenue has leveled off, and the difference between the fantasies of last June and the reality of today is worth over half of our funding problem. Another way to look at this is that are were many people in the statehouse who knew last spring that we would be exactly where we are today.

Health care

All state departments are beset with escalating health care costs. But so are all the quasi-public agencies, so are all the cities and towns, and so are businesses and so are citizens. There are things we can do about this, but the Governor does not have them on his agenda. We have a Health Insurance Commissioner now, but he doesn't really have the legal tools to limit health care costs, only to limit health insurance costs, which is not the same thing.

There are reform ideas that have been sitting around for years that haven't gotten any traction under this Governor. For example, whatever you think about Beacon Mutual's governance, the fact is that they have become a very attractive Workers Compensation insurer for businesses in Rhode Island. Their rates are quite low compared to other companies, and their commitment is to Rhode Island. Why can't we reform escalating medical malpractice insurance rates the same way? For that matter, what about health insurance itself?

The Governor hangs his hopes on increasing competition. Yes, it is true that competition is low in Rhode Is-

[1] This is the RIPR estimate. The public estimate from the legislature is about $73 million, but this is derived from analysis of 2005 tax data, and does not take into account the income growth we expect between 2005 and 2012, when the cuts will have their full impact.

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land, where there are really only two insurers of any note. But is competition a panacea? Statistics from the federal government show that you have to go as far as Pennsylvania to find a state where family health insurance premiums are as low as they are here. (See table 1.) Rhode Island premiums for single people, on the other hand, are as high as anywhere in the country. The other New England states have more health insurers than we do here, and so do New York and New Jersey. Since many of them also have higher family premiums, where is the evidence that competition alone will lower premiums? Could it be possible that we need competition for individual health plans, but not for family plans, or is it more likely that competition alone isn't going to do the trick?

	Family		Single	
	Premium	**Employee**	**Premium**	**Employee**
RI	10,220	2,309	4,368	794
CT	11,035	2,274	3,864	773
MA	10,559	2,784	4,141	885
NH	11,155	3,102	4,084	944
VT	10,690	2,657	4,074	744
ME	10,823	2,784	4,116	892
NY	10,397	2,090	3,882	714
NJ	11,425	1,885	3,858	613
PA	9,987	2,033	3,671	661
US	10,006	2,438	3,705	671

Table 1: The table shows the average premium for private-sector employees, and the average employee share of that cost. Source: Department of Health and Human Services, Agency for Healthcare Research and Quality, Medical Expenditure Panel Survey, 2004. See tables VIII.C.1 and VIII.D.1. You can find these at *www.meps.ahrq.gov/mepsweb*.

The Governor's budget also contains $20 million to automate health care record-keeping. The idea is to establish a "Health Information Exchange" system (HIE) that will make it easier for providers and insurers to share information, and therefore lower costs. But there seems to be no mechanism to make that second part of the equation happen. That is, it's fine to lower the costs of record-keeping to the hospitals, but exactly why should we pay for it from tax revenue without some way to insist—not just hope—that it will result in lower fees for care?

Education funding The education aid section of the budget has a heading that reads: "Local Education Aid up $46.4 million Or 5..4 Percent." This is generously described as an exaggeration. In the matter of direct aid, the kind that goes to meeting a school department's bottom line, here's the way it splits up: all the schools that the state itself runs will see their budget allotments increased 6-10%, because that's how much their costs are going up. These are the state-run charter Met School (10.4%), Davies Vocational (7.0%), the School for the Deaf (5.7%), as well as the Central Falls school district (6.9%) [*ES*D-3].[2] For these schools, there isn't anyone to foist the expense onto, so the increase in costs must be shouldered by the state.

All the other school departments in the state are run by cities and towns, and they have taxpayers of their own. So they are scheduled to get only a 3% increase, and their property taxes will have to make up the difference. In other words, the numbers contain an admission that justifiable expenses are going up much faster than the 3% offered. It would cost about $23 million to bring the state's school districts up to the funding increase seen in Central Falls. The budget could hardly be clearer in indicating that increases in local property taxes are an essential part of it. Since the property tax is regressive, this is a bigger impact on the poor than on the wealthy. Since the legislature has lowered the limits on property tax increases to a level well below any of the increases seen by the state-run schools, this is only slightly less direct than simply telling school districts to cut programs.

Unfunded liabilities The issue of the state's curious treatment of the pension fund's unfunded liabilities was explored in some depth in **RIPR** issue 9.[3] The short version of the story is that the pension system has a substantial "unfunded liability." This is the present value of the amount they expect to owe in the future, for which they don't have money put aside now. For private corporations, this kind of liability can be a big problem, since they can go out of business at any time. For governments, it's less of a problem, since the state of Rhode Island isn't going to go out of business. A public system can operate for years with a huge unfunded liability. The risk isn't failure, but that fluctuations in the investment markets can make the annual contributions hard to predict. Paying off the unfunded liability has nothing to do with the system's solvency, which is solely dependent on the credit-worthiness of the government that backs it. Rather, it's a way to make managing the system easier: a kindness to future taxpayers.

In 1999, the state embarked on a program to pay off the unfunded liability. This was a good idea, and it remains a good goal. But in 2000-2001, the stock market tanked, and achieving that goal became much more expensive. It's still a good goal, but like most goals, it's not good at any price. We are on a fairly aggressive path to repaying the liability. This is kind to future taxpayers, twenty-three years from now, but at a significant cost to the current ones.

The state could remain on track to reach the same goal, but put it off from 2029 to 2037, and save about $13 million on the state employee retirement system, and almost

[2] These are budget page numbers. "ES" is the executive summary, "B" the detailed budget, "P" the personnel supplement, and so on

[3] All the back issues are available at *whatcheer.net*.

$10 million on teacher pensions. Cities and towns would be able to cut their pension contributions by about 11% and save more than $14 million collectively.

The pension reform changes of 2005 made the system significantly less generous to teachers and state employees, while still requiring them to contribute the same amount of their salary. Lowering the employee contribution rate by one percentage point for state employees would cost about $8 million, and lowering the rate one point for teachers would cost about $9 million. This would still leave around $20 million in savings for the state and the towns, and would leave the system on track to retire the unfunded liability.

State debt The state debt was the subject of much of **RIPR** issue 22, where there's a diagram showing that state debt, after declining from $1.88 billion in 1994 to $1.28 billion in 2003, is now scheduled to go up to $2.13 billion in 2008. In other words, the debt reduction that took ten years, a lot of scrimping, and quite a bit of luck to achieve has been undone in Governor Carcieri's first term, and now state debt is up 66% in just five years. State revenue isn't up nearly as fast, and the total debt is now 62% of revenue, up from 46% when the Governor took office. A debt of $2.1 billion costs around $243 million to service [CC-31,C116]. In 2003, the total state debt cost only $122 million to service [CC-30 (FY04)].

This accounting counts both tax-supported debt and the GARVEE bonds we've taken on to pay for relocating I-195, building a highway and rail line to Quonset and rebuilding the Sakonnet River Bridge and the Washington Bridge over the Seekonk River. These are supposed to be financed with federal highway money, and not supposed to count as "tax-supported." The budget is, however, fairly clear that the debt service for this debt is displacing other expenses, so the distinction seems a bit forced. For example, the Governor proposes that $67 million in one-time funds be spent on roads, largely because the federal highway money is already dedicated to these five massive projects, and smaller but equally important projects are languishing because of it.

These road projects aren't *bad* ideas, but is that true no matter what they cost?

The last debt crisis

Our state has had a debt crisis before. After the RIHMFC credit unions closed in 1991, the state took on massive quantities of debt in order to pay off the depositors, but we raised a tax to do it (the sales tax), and the debt was paid off 22 years early. We also had a fiscal crunch shortly after, when the state's economy slowed and tax collections fell. The legislature balked for a year, but eventually voted to raise taxes on the wealthiest taxpayers via a modest "surtax."[a]

The Assembly and the Governor acted responsibly then, finding the money necessary to keep the government solvent. We survived the trauma of raising a tax, our bond rating went up, we serviced our debt, and everyone went on to have a grand time in the booming 1990's. Isn't the lesson that responsibility is a good idea?

[a] This lasted until the Clinton tax changes in 1995, when the state tax administrator unilaterally repealed it while the Assembly was out of session. No legislator could be found to sue the administration for undoing this act of the Assembly.

Revenue There are some tax changes due to happen this year. They are not proposed in the Governor's budget, since they passed in previous years. The budget does not anticipate revisiting those changes where they would benefit our richest taxpayers, but it does revisit the changes that would benefit the well-off middle as well as the rich.

Capital Gains A few years ago, Massachusetts eliminated its tax on long-term capital gains. In response, the Rhode Island Assembly passed a law phasing ours out, too. Since then, Massachusetts lawmaker thought better of the idea, and reinstated the tax. We have not, and it is still on schedule to be phased out. The tax is 1.7% for tax year 2007, and goes to zero in 2008 for capital assets held more than five years. It's worth noting that the capital gains rate had *already* been cut to 5% a few years before this tax cut was passed. Almost all people who earn capital gains pay state tax on regular income at a higher rate than this.

The original rationale for this cut—that we have to remain "competitive" with Massachusetts—was shaky, and now it's gone completely. But the law will still phase out the tax next year, and lawmakers don't see anything wrong with that. Reinstating this tax would probably raise in the neighborhood of $40 million next year (and $26 million in the current year) according to Poverty Institute estimates.[4]

Income Taxes Last year, the legislature passed a cap on the tax of very wealthy individuals. The idea was that we should lower our top rates to the equivalent rates in Massachusetts, to prevent our rich people from fleeing to Attleboro. In 2006, the top tax rate was 9.9%. But no one was charged that tax rate on all their income; the first $50,000 that anyone earns is taxed at 3.75%. Only the income beyond around $350,000 is taxed at 9.9%.[5]

In 2006, the legislature changed the law so that there is now an effective cap to the tax rate. Without this cap, someone who was paid $700,000 a year (gross income)

[4] House Finance estimates are that the money raised would be $26 million next year, but estimating the impact of this kind of tax is especially fraught because of a lack of useful data.

[5] This is for families. For single people, or "head of households" the limits are different.

would pay about $51,000 in tax. Starting from the taxable income, this works out to an effective rate of 8.5%. With the new cap, that person would only pay 7.5%, and save $6,000. Next year, that person will pay only $42,000 and so on, until their tax goes down to $33,000 in 2012, saving him about $18,000. The tax cut this year will have no effect on any taxpayer earning less than about $375,000. According to statistics from the state Tax Division, there are about 2800 such taxpayers, and about two-thirds of them live in other states, which is somewhat ironic for a tax cut intended to keep rich people here. The total cost for this tax cut is about $16.5 million in FY08, rising to well over $100 million in 2012, when it is fully phased in.

Car taxes When you talk to budgeters, they say we have to keep our promises to the people affected by the income tax cut and the capital gains cut, but there is a previously-scheduled tax cut that the Governor says we can't afford to continue. This is the car tax phaseout. Right now, the state pays the property tax on the first $6,000 of a car's value. The exemption had been on track to increase $500 each year, but he says we can't afford it, so it stops here.■

How did we get here?

The conventional answer to how the state got in this fiscal pickle is a pretty simple one: escalating "entitlement" costs and union demands made the cost of government go up faster than revenues. It's a simple story, but by overlooking some other very powerful contributors to the current mess, it's also wrong.

The costs of social services have gone up. Increasing demands on our schools, especially special education services, have sent education costs way up. Health care costs have risen very fast, and pension expenses, too.

But consider these:

- Corporate taxes have declined from 14% of the general revenue in 1990 to less than 7% today. In today's dollars, this is around $200 million in lost revenue.
- We've cut the capital gains tax twice, and are still on track to phase it out entirely on assets held more than five years, and at a cost of about $40 million.
- The personal income tax was cut 9% between 1997 and 2002, costing us about $110 million this year.
- The phaseout of the car tax is costing $140 million this year.
- We've cut taxes on the richest taxpayers to a degree that will eventually cost us $100 million.

In addition to these, the state has taken on over $100 million in additional debt service since 2003.

Most of these tax cuts (and much of the borrowing) were intended as economic boosts of one kind or another. The cut in the capital gains tax supposes that it will encourage investment, the cuts in the corporate taxes[6] were meant to encourage one industry or another, and the income tax cuts were thought to be an economic stimulus. The state has a place in stimulating the economy, but how much stimulus is enough, and how expensive does it have to become before it is no longer cost-effective? The list above contains well over half a billion dollars *per year* in "stimulus." What do we have to show for it? When is enough enough?[7]

While the state was slashing these revenue sources, the cities and towns were finding themselves forced to raise property tax rates, year in and year out. Property taxes hit the poor harder than the rich, while state income and corporate taxes tend to fall on the rich more than the poor. The effect of the last 15 years of state tax policy has not been just to cut taxes, but also to shift the taxes from the rich, to the poor.

It's against this backdrop that the Governor's proposed cuts in social services should be viewed. Welfare recipients haven't had a cost-of-living increase in their allotments since 1989. But the property taxes they pay through their rents have not been similarly stable. Meanwhile the income taxes of the wealthiest Rhode Islanders have been cut multiple times: the capital gains tax cut twice, the income tax cut twice, and the corporate taxes trimmed.

[6] These are several different taxes, with several different cuts.

[7] And do these schemes even work? An article in **RIPR** issue 10 reviewed the available evidence about tax incentives and corporate location decisions.

Seeing it coming

In 1997, the legislature proposed cutting the car tax, and then-Governor Almond proposed a 9% cut in the income tax. Neither would agree to support the other's proposal, but neither would argue against the other's proposal, either. So they both passed. This year, the car tax phaseout will cost the state $140 million, and the Almond income tax cut about $110 million.

In a 1997 conversation with Michael O'Keefe, then as now the chief Fiscal Advisor to the House Finance Committee, I asked whether he thought phasing out the car tax would be too expensive to do if the state also passed the income tax cut. His reply was, "The Chairman [then-Representative Tony Pires of Pawtucket] feels that the state would benefit from increased fiscal constraints in future years." Well here we are. –TS

Fifty-year version There's a longer-perspective version of this story, too. In the 1950's and 1960's, the greatest demographic shift of the 20th century came with the creation of the interstate highways. Rt 95 and 195 provided easy routes to the suburbs, and people took them. As people moved out of the cities, and adjusted to commuting, the tax rolls there declined. In the suburbs, the opposite was happening, as people moved into once-sleepy little towns, swelling their tax collections. From the city's perspective, this was a fiscal disaster, and meant declining revenue to service the population that remained. Meanwhile, the opposite was true in the suburbs, where towns could finance increased services on their growth without raising taxes. This kept taxes low in the suburbs, while pushing them up in the cities, which only made the situation worse, by providing a financial incentive to move.

In the 1960's, Governor John Chafee was perceptive enough to notice what was going on, and saw that the local nature of the property tax was creating the pressure on the cities that was not shared by the suburbs. He wound up sacrificing his governorship in an attempt to establish a state income tax to take some of the pressure off the property tax. He lost his bid for re-election to a tax-baiting Frank Licht, who waited a term, then tacitly admitted that Chafee had been right and passed a state income tax. Unfortunately, the tax wasn't significant enough—and town-state relations too rocky—to make a dent in the property taxes.

Financing a town's services on its growth can't last forever, but only while there is land enough to build on. As our suburbs reached full build-out, where all the zoned land is in use, they discovered that without growth, their tax rates were not sufficient to pay their bills, and found themselves forced to raise taxes (as well as to approve dumb developments). The scene has played out in town hall after town hall, as people show up to town council meetings, irate about their taxes. (After all, many moved to the suburbs for the low taxes.) Warwick and Cranston hit this wall in the early 1990's, and it's spread since.

So that's the choice. You can believe, with the Governor, that our fiscal crisis is the result of self-indulgent poor people and greedy unions, or you can see it as a result of epochal demographic shifts in where we choose to live, compounded by bad fiscal choices made in an attempt to stimulate our state's economy. If you agree with the Governor about how we got here, there is little to do but cut everything and cut deeply. But he gets to his conclusions by ignoring important facts. There are other choices we can make, and the less fortunate among us are depending on us to make them. ■

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