Rhode Island Policy Reporter

Issue 25 **10 May 2007**

Moving, the issue

WHEN DISCUSSING THE STATE BUDGET, it's almost impossible to avoid discussions of municipal finance. Between education aid, building aid, support of teacher pensions, payments in lieu of taxes, and all the other forms of local aid, quite a lot of the funds raised by state taxes are expended at the cities and towns, or on their behalf. Figuring out the exact number is a challenge, since a number of money sources seem to straddle definitions. Is establishing a statewide math curriculum aid to towns? What about federal grants that pass through the state en route from Washington to Foster? And what about teacher retirement assistance funds: given to the towns in order to be paid right back to the state? The Governor and legislators are inclined to be generous in their counting, and by their count the state budget counts $285 million in direct aid and tax money that comes from the state and goes to cities, towns and fire districts. Then there is another $910 million in aid to schools (including those pension fund payments). All told, about a third of the taxes the state collects go to support the state's local governments, and these make up between 15% and 45% of city and town revenues, depending on the town.

This, of course, is a tremendous bone of contention at the statehouse, where it is widely assumed that local governments accept the state's money in order to flush it down the toilets back at town hall. This may seem a harsh assessment, but consider the evidence:

- The Governor proposed to award all the state-run public schools budget increases of 6-10%, since that's how much their costs rose. The municipal schools got 3%.
- The Senate last year enacted strict limits on town budgets without promising any compensating money, as if to say, "We're not sure what you're spending money on, but it certainly isn't very important."
- The Governor's 2008 budget Executive Summary has a heading "Encouraging Local Government Efficiency" which is really a proposal to hire three new state workers to help give towns less money to build schools.
- The Governor's budget contains no increase in non-education local aid, except for pass-through money over which the state has no control. Yet the state budget will go up, as will the municipal budgets.

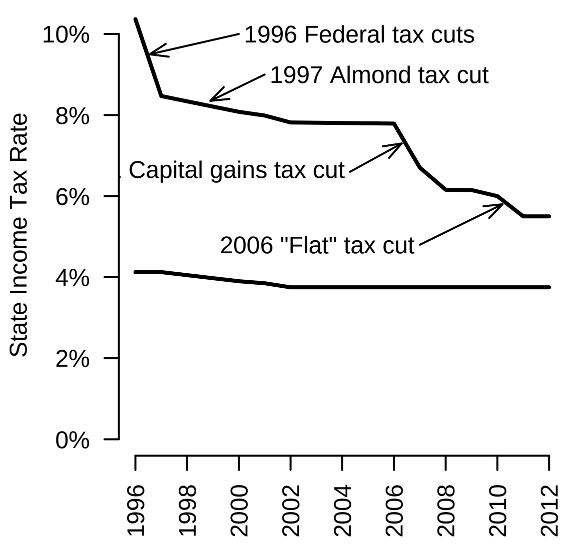

Figure 1: Rhode Island income tax rates. The bottom line is the tax rate applied to a family with taxable income at the median. (Half the families in the state have higher incomes, and half have lower incomes.) You can see the effect of the Almond tax cuts in the rate decline between 1998 and 2002. The upper line shows the tax rate applied to a family in the top 1% of income, who had about a third of their income from capital gains. Remember this graph the next time you hear complaints about the state budget deficit. If the state restored the income tax rate to the bad old days of 1996, it would bring in $110 million, about half the projected deficit.

Consider this, too: Over the past 17 years, the property taxes collected by all the towns in the state have risen, on average, at about 4.5% per year. The state income tax collections are up by an average of 5.4% per year. But the income tax *rates* are down as much as 40%,[1] depending on your income (see Figure 1) while property tax bills have skyrocketed everywhere. For all the groaning about tight budgets heard around the statehouse, the state has a far easier time earning the revenue it needs to operate than do the towns.

The usual villains identified in this story are public employee unions, along with too-pliant city officials. Certainly the unions are part of the story, but are they really so strong? Are they really so evil? Here's one problem with the story. If you believe that unions are the problem, or that bad management is, then why are some towns doing so much better than others? Union contracts statewide differ in the details, but not in the broad strokes, and city and town managements seem to be drawn from the same corps of people. North Kingstown recently replaced its town manager, who moved on to manage things in Coventry. To replace him, they hired a guy who used to be the town manager of Middletown. Middletown, in turn, is now run by one of his former deputies, and another oversees finances in Portsmouth. Certainly there are differences among these guys, but

[1] This would be true for a wealthy family (top 5%) with substantial income from capital gains. For lower-income families with only wage and salary income, the decline is only 9%.

to imagine that they are the biggest differences between towns seems unlikely.

A Tale of Two Towns It's interesting to compare Portsmouth and Middletown. These two towns have about the same population, sit next to each other on a small island, and have about the same tax rate. That's about where the similarities end. Portsmouth is in the throes of a fiscal crisis, and is skirting disaster as it tries to squeeze through the current fiscal year, while Middletown has just had its bond rating upgraded to one of the highest in the state. Portsmouth has a well-organized political faction, the "Portsmouth Concerned Citizens" who last year engineered a substantial cut to the school budget at a town financial meeting. Middletown has concerned citizens, but nothing nearly as well organized or militant.

When you ask people in each town what's so different about them, they'll point to the fact that Middletown has more commercial property and this lowers the tax rate on residential property. Unfortunately for this theory, the residential tax rates in the two towns are within a few percent of each other. (Due to the budget disputes, Portsmouth has had three rates this year.)

Here's one difference between them: they are the same size now, but they got there in very different ways. In the heyday of the Navy's presence in Newport, Middletown's population was almost twice what it is now. Portsmouth, on the other hand, has been growing at a pretty good clip since the 1940s, though it has leveled off in recent years.

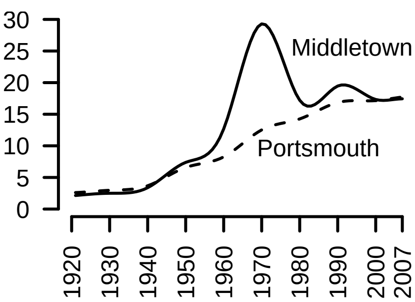

Figure 2: The population of Middletown and Portsmouth (in thousands). The two towns are the same size now, but they got there in very different ways, and the fact has long-term repercussions for their budgets.

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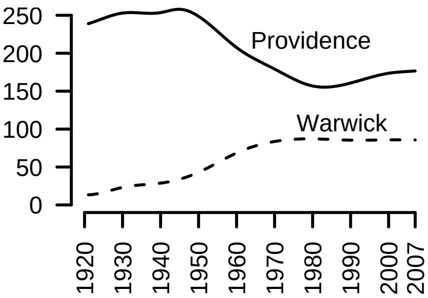

Figure 3: The populations of Providence and Warwick (in thousands).

Digging a little further into their history, it turns out that Middletown suffered a fiscal crisis a few years ago, at the end of the 1990's. As was noted before, their finances are fine now, but for a while they were looking at the same kinds of problems as beset Portsmouth today.

When analyzing real-world towns, there are a million variables to consider, and it's difficult to figure out which are the important ones. When scientists are faced with problems like these, they often turn to computer models to work out the issues. So I created a computer model of two towns on an island, sort of a modest little SimCity. Each town has about 25,000 people, and has a school population, a retired population, a town budget and a property tax rate to fund it. To keep things simple, there is no inflation in this magic world, and everyone lives in identical houses. But there are a couple of key assumptions. One is that when a town accommodates to its population, it makes certain commitments: building a fire station implies a commitment to staff it, building a road creates a commitment to keep it clear of snow, and building a school implies a commitment to teach the children who attend it. These commitments are not forever, but they cannot be changed in a single year, and some of them last for several years. The other key assumption is that it takes a little while to add new capacity to the town. The demand for a new school, road or fire station has to exist for a few years before it can be accommodated.

It only takes a slight movement of people to wreak fiscal havoc in a town.

Having set up these two little towns, they happily grow at a modest pace each on their own end of the island. The property tax rates rise at first, but then stabilize nicely. (In the real world, this might correspond to the rate rising at the same rate as inflation.) All seems well, until you start moving people from one town to the other. With a set of reasonable assumptions about the sizes of the budgets and the values of the housing, migration rates as little as 1% per year can have the effect of raising taxes in *both* of the two towns. In the town losing population, the decreasing tax base has to share essentially the same level of services, and so taxes go up.[2] In the town gaining population, taxes go down for a few years, but then start rising because the taxes contributed by the new residents don't cover the costs of the services they require. Then they really spike up when the population growth levels off. A few years after you stop moving the population, the taxes settle down again, but at a higher level than if no movement had happened. Again, the only assumptions used here were that it takes time to adjust a town's capacity to fit its population, if that population changes too quickly.

Could capacity issues plus people moving from one town to another be responsible for high property taxes?

This is way too simple an island to tell us much about the real world, but it does suggest that it doesn't take very much movement of people to wreak fiscal havoc. And in case anyone's forgotten, postwar Rhode Island saw migration rates many times this, as people fled Providence and the other cities in favor of the suburbs. Taxes in Providence rose quickly as the tax rolls declined, and taxes in the suburbs stayed modest only a bit longer before they, too, began to rise. The villain isn't unions. Even if union contracts are among a city's important commitments, so are buildings, bonds, and political promises to constituents. This is simply the nature of municipal government. It takes time to build capacity to serve a population, and you can't shrink it with a magic wand, either.

Providence has two-thirds the people it had fifty years ago, but it still occupies the same area, which means it still needs roughly the same number of firefighters that it had back then. The cost of those 400-odd firefighters is now borne by 175,000 people instead of 250,000. Warwick's population curve is shown in the accompanying figure. Their tax revolts began in the late 1980's, when you can see population growth leveling off.

Getting back to the real island, Middletown's recent fiscal crunch came at the heels of the population decline it saw in the 1990's. Since then, growth has been modest, and that's no problem. For Portsmouth, growth is also modest, but it's leveling off after a long period of energetic growth. The situation in each town is the same, but the history of how they got there makes all the difference.

What this suggests is that capacity issues may be at the root of Rhode Island's property tax problems. It may simply be that in a world where moving fifteen miles isn't a big deal, towns that span only four miles may have a difficult time adjusting to changes and controlling the costs of the many services they provide. ■

[2]People moving from a town do leave their houses behind, but in declining towns and neighborhoods, the collection rates tend to drop dramatically.

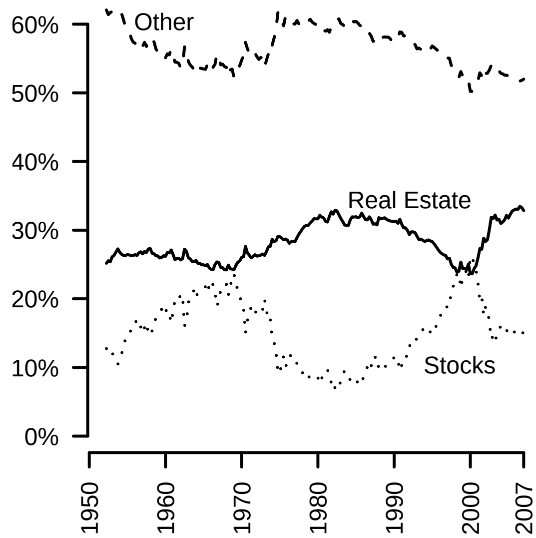

Figure 4: Investments as a proportion of overall household assets. The "stocks" line contains both direct holdings of stock and ownership of mutual fund shares.

Investment and taxes

A great deal of the tax-cutting we've seen in Rhode Island over the past fifteen years has been in service of economic development. The idea is that cutting the taxes on wealthy people will provoke them to invest in the state's economy, thereby creating jobs for thee and me, too. This theory rests on an uneasy foundation: we can cut taxes as we please, but we can't force the people who receive our largesse to invest in new businesses. State policy makers simply assume they will, and hope for the best.

We don't have to fly blind, however. The Federal Reserve publishes reams of statistics about our nation's investment habits, and they can tell us something about how it all works. Figure 4 updates a graph first shown in **RIPR** issue 15. It shows the evolution of levels of household investment in real estate and the stock market since the 1950's. Each line shows the proportion of all assets invested in real estate or stocks.[3] You can see in the graph that real estate investment and investment in the stock market are almost mirror images of each other. This tells us something about the nature of real estate investment, and the earlier article was a discussion of the effect of this nature on the price of housing. Articles since then (see **RIPR** issue 16 or 23) have detailed how the high levels of speculative real estate investment have disrupted the housing market and inflated the prices of housing beyond affordability for many.

But back to the graph. What's also interesting about it is that the mirror nature of the two lines changes over

[3]This is for households and non-profit organizations—for-profit corporations are excluded here. Households and non-profits account for about 40% of all the financial assets in the country, and about 75% of the real estate. Households alone hold about two-thirds of the real estate.

time. Before the mid-1980's, the two lines were clearly moving in opposite directions, but not at the same rate. Since then, though, the seesaw effect has become much more pronounced, with the two nearly in perfect opposition since 1997.[4] This has important implications for both the real estate market and the stock market. For one, we can expect to see booms in one market whenever there is a bust in the other. This, of course, is what's happening right now, with the Dow Jones at euphoric highs while the real estate market sinks into despair. After the crash in 2000-2001, the stock market continued to sink and didn't start to rise again until sometime in 2003, and that's just when investment in the real estate market peaks, as you can see in the graph. So, based on this, we can predict that the current run-up in stock prices will last about as long as the housing slump we're in now. When you start to see encouraging press releases from the RI Association of Realtors, sell your blue-chips.

Why is this? Aside from a brief period in the 1960's, this situation is a recent development. Changes in the "other" line kept them from moving together. This category includes investments like washing machines, cars and riding lawnmowers, but also includes bank deposits, pension funds, and equity in non-corporate businesses, which are shown in figure 5. Pension assets took a beating after 2000, but are still up by a lot since the 1950's. Bank deposits are down, too, but the real eye-opener is the decline in business equity—the value of privately-owned businesses—as a proportion of household investments. These businesses include all partnerships and sole proprietorships, as well as limited liability companies. This means they include many small businesses, but also many large law firms and investment brokerages. They once accounted for more than a quarter of all private assets, but are now down to 10%.

[4]For the numerically inclined, the correlations between the two improve dramatically over time, as do the residual errors for fitted lines.

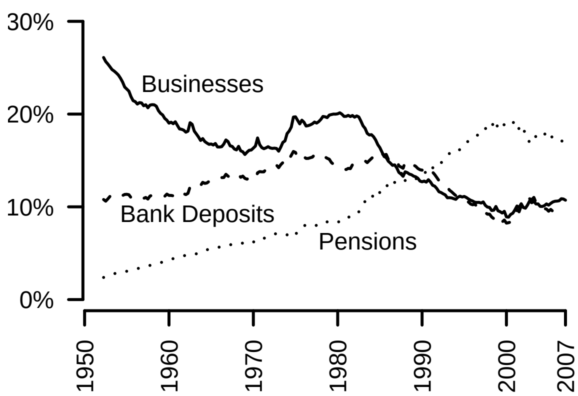

Figure 5: Other investments as a proportion of overall household assets. These are part of the "other" line in the graph on page 3. The solid line is the value of non-corporate business ownership, i.e., partnerships, LLCs and small businesses.

Corrected for inflation and the increase in population, the value of these businesses are up about 40% since the 1960's. A significant amount of that is only the appreciation of the real estate owned by the businesses, so the real number is only about 25%. This is especially odd since quite a lot of the appreciation in this category is due to the recent introduction of the Limited Liability Corporation (LLC). This form of corporate structure provides some of the important features of a real corporation to a much less complicated partnership, and has become quite popular in the last 20 years as an alternative to corporations. But even with this boost, the appreciation has been meager. Compare this to overall corporate values, which are up more than eight times as much over the same time period. Why should these businesses have declined so much in their importance to the economy?

Economists no longer worry about vanishing opportunities for investment. Maybe they should.

In the 1930's and 1940's a perceived decline in opportunities for productive investment was a hot topic among economists. This was one of the big puzzles presented by the Great Depression, where it appeared that there was plenty of money to invest, but nothing worth investing in. Alvin Hansen, the Harvard economist who became the most prominent interpreter of Keynes's theories in America, theorized that it had something to do with the end of the country's geographic expansion. Joseph Schumpeter, the famous Austrian economist, claimed that it was a sign that the risk-averse culture of the welfare state had sapped the vital juices of the entrepreneurs needed to make the capitalist system work. The debate raged.[5]

Meanwhile, World War II ended, and after it there was a tremendous burst of investment as companies rushed to fulfill four years of pent-up demand. Suddenly, the debate between Hansen and Schumpeter seemed quaint. This was Keynes's answer to the stagnation problem: if there's enough demand, investment will happen. His explanation of the Depression, and the one most widely accepted today, is that there simply wasn't enough money in the hands of people who wanted to buy stuff. Deficit spending was a way to put it there, and the increase in demand created the opportunities to invest. The problem of vanishing opportunities is pretty much a dead issue among economists today.

But ask yourself now: if $40,000 dropped in your lap, how would you invest it if you couldn't put it into stocks

[5]For more, see Alvin Hansen, "Full Recovery or Stagnation?" W. W. Norton, 1938, Chapter 19. For Schumpeter, see "Monopolization and the Decline of Investment Opportunity", by George W. Hildebrand, American Economic Review, Vol. 33, No. 3 (Sep. 1943) pp. 591-601.

or real estate?[6] What productive investments could you make with that money? If you have trouble thinking of something to do, you're not alone, and this is probably why the Federal Reserve statistics show money sloshing from real estate to stocks and back again: what else is there? A generation ago, Rhode Island boasted dozens of small plastic-molding companies, each of which owned a handful of injection- or blow-molding presses. These were started to fulfill demand from Hasbro and the costume jewelry industry, but came to serve a national market for plastic parts. The barriers to entry were low—some space and money for a couple of machines—and the demand was high. Those shops required the services of skilled machinists to make molds. The startup capital for a machine shop is low, and the demand was high. These were opportunities for productive investment on a scale that could be embraced by an uncle called upon by his nephew or by a small collection of partners. Banks can sometimes be involved, but many businesses start with capital raised less formally, through family and friends. Fishing boats are another such opportunity, as are retail stores and restaurants.

In 2007, which of these opportunities remain? Hasbro has exported all the plastic molding jobs to China, lots of the presses and stamps of the costume jewelry industry have gone, and the fishing industry has taken a nose-dive. The retail and restaurant options remain, but in a world dominated by Wal-Mart, Home Depot and McDonald's, which are the retail niches that can be profitable on a small scale? The existence of both Staples and OfficeMax means that neither is a monopoly, but that's of little consolation to someone who wants to run a small stationery store. There are new niches to replace some of these old ones, but if you find one, you'll likely find yourself competing in a global market from the beginning. This is not necessarily comforting to a prospective investor, and can make a productive opportunity seem unattractive. It may well be that we are in a situation like the 1930's in some respects, where attractive opportunities for productive investment are hard to find, even at the same time the aggregate measures of investment don't show a problem.[7]

What productive investments would you make if $40,000 fell into your lap?

When one family member loans another some money to start a business, or when someone invests his or her savings in equipment for a business, this investment isn't caught in any of the Federal Reserve's measurements of our economy. (Though eventually the value of the successful businesses will be reflected in the statistics shown in the graph on page 4.) This is a part of the "informal economy," usually deemed of secondary importance. Secondary doesn't mean insignificant, however, and recent work has shown that in many economies, the informal sector is responsible for quite a bit of investment. A 1998 study of the Atlantic provinces of Canada used a random sample of businesses to conduct a survey about the use of informal investments.[8] The report's author found a surprisingly high percentage of new businesses had used some kind of informal money as startup capital. Using that report's estimates of activity, Rhode Island might see around $60-65 million in informal investments in new businesses each year. This economic activity is not noticed by the standard statistics, but the secondhand evidence from those statistics is that it has been in decline for years.

Informal investment isn't caught in official statistics, but that doesn't mean it's unimportant.

The aggregate measures miss some important detail, too. When a local business opens, there is all kinds of investment that translates into the local purchase of goods: tools, computers and machinery, perhaps, but

[6] Or drugs or high-stakes poker. We're looking to create jobs here.

[7] The aggregate levels of investment aren't booming, either, though they don't show any sign of drying up completely.

[8] "Informal Venture Capital Investment in Atlantic Canada" by A. Ellen Farrell for the Atlantic Canada Opportunities Agency, February 1998.

also desks, chairs and heating equipment. Some of these goods are purchased nearby, and so the investment turns into spending. When a national chain opens a new store, there may be some investment, but it happens back at corporate headquarters, where corporate architects draw up the plans, corporate purchasers plan the furnishing and corporate construction staff come out to supervise local crews. The reigning theories of economics say that investment today stimulates demand tomorrow, but if investment in Rhode Island stimulates demand in Georgia or Arkansas, then what good is that to us?

So what? What's important here is to notice that the aggregate measures of investment utterly fail to capture the losses of small-scale investment oppportunity that were so easy to catalog above. These aggregate measures are what the dominant economic theory is based upon. For people who believe in that theory, the fact that we have an economy with booming corporate profits but low levels of investment and stagnating real wages is a conundrum. For people who notice a qualitative difference between investment in a new Home Depot and investment in a local hardware store, the conundrum is about the economists.

This is not just an idle excursion into economic theory. State and local taxes have been cut time after time to "stimulate the economy." We cut capital gains taxes to encourage investment, we've cut the income tax on the richest of the rich to encourage them to live and invest here. But this prescription presupposes a shortage of capital and a shortage of investors. On the contrary, the data—from the Federal Reserve, from the Providence Assessor's Office and RI Housing (see **RIPR** issue 23), and from our own eyes—clearly show that our poor state is awash in capital sloshing back and forth between the stock market and the real estate market. Our economy is a capital-producing machine, creating a tremendous reserve of investable funds each year, but providing few productive ways to invest it. Our problem isn't a lack of rich people or a lack of money to invest. Our problem is that the business opportunities that once were easy to find are no longer so easy. If the state wants to help stimulate new investment, helping create still more capital is absolutely the wrong way to do it.

A huge propensity to save and nowhere to invest is a recipe for stagnation. And tax cuts won't help.

How, then, do we stimulate new investments? In the 21st century, ideas are more valuable than capital. Protecting and promoting people who have those ideas and finding ways to connect them to investors would be more valuable than simply rewarding investors who haven't done anything yet. But even these are dicey strategies.

The only proven strategy for coming up with new investments is to educate our children to find them. Teach them about the rest of the world so that they will be able to see opportunities that others don't. Teach them about technology and science so they'll be able to exploit the opportunities that others can't. Teach them art and music and theatre so they'll be able to make opportunities that others will never think of. Instead of continuing to shower rich people with tax breaks they probably won't use to our advantage, why don't we try that? ■

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