Rhode Island Policy Reporter

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Goin' Places

As the Assembly debates tax policy this year, once again the issue of moving rich people has arisen. The fear is that "raising" taxes on the very wealthy will cause a mass exodus. Never mind, of course, that we're in year three of a multi-year tax cut for those same people.

It turns out that where people move to is also a subject of some interest to the IRS, which publishes migration reports for states every year. Shocking, you say, there's actual data? Come, tell me if it's true: Are rich people leaving our state?

Indeed, the data do not lie: they are leaving, by the thousands. Of course, the data also show us that other rich people are *coming* to the state, also by the thousands. There is no denying the troublesome news for Rhode Island in these reports, but it's certainly not what you hear on a typical afternoon on WHJJ.

I bought five years' worth of this data, for years between 1989 and 2006. Each year, the data show the number of tax returns filed by people who arrived here, and what state they came from, the number who departed, and where they went. There are also estimates of the income earned by the migrants in their new state. Like all data sets, there are some limitations, most obviously that this only applies to people who file tax returns.

That said, what do we see? The most interesting, and highest volume, exchange is with Massachusetts. In 2006, 4,538 families (7,614 exemptions, most of which are people) moved from Rhode Island to Massachusetts, where they collectively earned about $218 million. That same year, 4,199 taxpayers (6,679 people) moved the other direction, and they earned $196 million here. Net, we're down 339 taxpayers (and their families, where they have any). So who are all these people? The data don't have a lot to tell us, but we can say that both groups have fewer children, and earn less, on average, than Rhode Islanders who stayed behind. The departures earn a bit more than the arrivals, but it's quite close ($48,100 vs. $46,800). To me, the small number of dependents and the respectable-but-modest incomes sounds most like the movement of young professionals, looking for better work.

Five years ago, the story was different. That year, only 3,825 people moved from here to Massachusetts, while 4,708 moved the other way. The average income of the arrivals that year was significantly higher than the departures, too. (Though again, neither was as high as the incomes of people who stayed put.) Of course, that was the year that the high-tech industry in Massachusetts really tanked. The jobless rate was much lower here. Before that, in 1997 when the jobless rate was the other way around, the flow was the other way around, too.

The measures of income in this data can be misleading, since you can't tell whether this is income a migrant takes with him or her. That is, someone moving to another state might be taking their income with them, if it's a pension or investment income, or moving in order to take a job in that state. Both cases would look the same in these data.

Nonetheless, I learned something from how the incomes flow. Take Florida as our second example. There is a significant difference between the low incomes of the 984 taxpayers who moved here from Florida and the 2,529 who moved the other way. Again, however, the incomes of the leavers are, on average, lower than that of the people who stay. Doubtless plenty of wealthy people move to the Sunshine State. But for every migrant who earns $200,000, there are apparently 15 families in the $44,000 range making the same trek, leaving the mean a bit less than $54,000.

Several states send us rich people. New Jersey, Maryland, and Ohio seem to be major sources of wealthy people. (Along with Connecticut and Virginia, until recently.) Migrants from those states have incomes substantially higher than the incomes of people already here. Except for New Jersey, the total flow of people is currently from Rhode Island to these states, but apparently we're getting wealthier taxpayers than we send them in exchange.

One of the troubling signs apparent in these data is a loss of children. The Pied Piper apparently marches south from here, and you can see a fairly large loss of families with children, mostly to the south (except Florida). The incomes of the departures to and arrivals from southern states are all lower than the incomes of stayers, but the net flow of children is clearly south.

To be quite clear, this data isn't detailed enough to do anything more than suggest what's going on. It doesn't tell us exactly who is doing the moving, or why. The broad pattern is essentially the same as we learn from Census data. Rhode Island is losing population, and has been since economic conditions in the rest of the country

improved in 2003-2004. Families with children seem to find life congenial in the south; people with average incomes and few children frequently move to Florida; single people find opportunities elsewhere, but especially California, Washington, Oregon and New York. Meanwhile, relatively wealthy folks from New Jersey, Connecticut, Maryland and Virginia seem to find life satisfying here. None of this is particularly earthshaking news.

Though the data can only suggest what *is* going on, it can be much clearer about what *isn't*. You can't exactly tell who's coming and going, but the data clearly show that wealth is mostly staying put. The mean income of departures is much lower than those who stay, both overall as well as for all but a small handful of direct comparisons. The only two of those that receive appreciable numbers of Rhode Islanders are Illinois and Ohio, where the traffic is less than 200 taxpayers in either direction.

It would be very challenging to use this data to support a theory that wealth is flowing from Rhode Island, except inasmuch as it flows with people seeking their as-yet-unrealized fortunes elsewhere. Those people are our future, so cannot be ignored, but to imagine that tax changes to favor wealthy people are the only, or even the best, solution, is only fantasy. A healthy economy requires investors, certainly, but it also requires workers, infrastructure, educational opportunity, markets and much more. To focus state policy solely on investors at the expense of the rest, as we have done and are doing, is to miss most of the picture of what makes a healthy economy, and will only drive more young people to look for opportunity in other states. ■

Entitled to complain?

Everyone thinks they know what "entitlement" means. The Governor says it means welfare, in all its forms, and in his budget, he points out that 41% of the state budget goes to "Assistance, Grants and Benefits." Shocking, no?

But "Assistance, Grants and Benefits" has a technical meaning, too. It's just an accounting category, like "Personnel" and "Supplies," available to any state department for classification of its expenses. That's why it includes unemployment, TDI benefits, and financial aid for public college students as well as federal grant money that passes through agencies like the State Police and Department of Transportation, and money we pay to the Historical Society for their services (see box, p. 3).

So when you hear that $2.8 billion of the state's budget is in this category, do you immediately think, "Wow, that's a lot of welfare?" Many people do, and that's a shame because they imagine somehow that kindness to the poor is what's breaking our budget. Welfare, cash payments to poor families with children, makes up only a tiny fraction of this money: about $55 million. The "exploding" cost of child care benefits is around $50 million. For the two programs together, we receive about $80 million in federal funds. Were we to eliminate this program entirely, we'd give up those federal funds and save $25 million, hardly even denting the deficit.

So what *is* this money? Twenty percent of it is those Unemployment and TDI payments, 20% is an assortment of everything else, including those grants and tuition aid, and around 60% is Medicaid funds of one kind or another. "Aha!" you say. It's not welfare, but it's medical care to the poor that's killing us. Let's look at those.

Medicaid provides medical care to three categories of people: the poor, the disabled and the elderly. These categories overlap a lot, but that's how the government classifies it. RIte Care is the managed care program—a system of clinics around the state providing care to the poor—and is the program you might think of when you think of Medicaid. We appropriated $193 million in state tax money for this program last spring, and another $224 million in federal dollars. The Governor's supplemental budget would cut the state's contribution by $13 million for this fiscal year, mostly by raising eligibility requirements and kicking people off welfare after two years instead of five. His FY09 budget would have this number at $183 million, saving around $12 million in state money and foregoing around $14 million in federal dollars.

$183 million is a lot, but one can't help but notice that it's only 6.5% of the number cited as "Assistance, Grants and Benefits" and about 5.6% of all the tax money we expect to collect next year. Is this what's breaking our bank?

The rest of Medicaid is a mixed bag. There's $20 million in federal special education funds, distributed to local schools, and $114 million in money paid to hospitals for the care of the uninsured poor, and after that, it's mostly care for the elderly and disabled, which is the real bulk of Medicaid. There's a fair amount of inefficiency in this spending. Care tends to emphasize nursing homes over much less expensive and generally more humane long-term home care. Advocates for the elderly and disabled have been pointing this out for years, and at last the Carcieri administration is coming around to the view.

Unfortunately, they're coming around to it in the worst possible way. When people say that you could save a lot of money by changing some policy, they don't nec-

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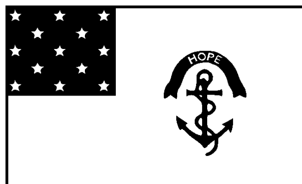
Raising the Battle Flag

It turns out that a tiny part of the "Assistance, Grants and Benefits" category is paid to the Rhode Island Historical Society for maintaining the state's collection of artifacts, like the battle flag of the First Rhode Island regiment, the first all African-American regiment (well, not counting the commanders).

The First Rhode Island has a fascinating history. Recruited in 1778, the regiment fought in the Battle of Rhode Island, where the American army lost, but was able to escape due to the bravery of the 1st RI, the last regiment left in the fray. (Do you wonder why?) They later fought again in actions around New York, and in Yorktown.



The regiment was largely made up of slaves, who were promised freedom after the war. How were they recruited? That is, how were their owners persuaded to, ah, contribute to the war effort? Call it the old-fashioned way: The state bought the slaves—up to $400 each, well over 50% higher than the market price at the time.[a] In fact, because of the British blockade, the Newport slave traders weren't able to ship their "product" to markets in the south, and sales had pretty much stopped for the duration. Would it be uncharitable to call this a bailout of a few well-to-do Newport slave traders at public expense? Better to call it a "win-win" situation. Combining profit and patriotism? Rhode Island is where it all began. –TS

[a]See Eltis, Lewis and Richardson: *Slave Prices, the African Slave Trade, etc.* Journal of Economic History, 2006 (66) pp1054–1065.

essarily mean that you could save it all in one year, but that's what's on the table. Governor Carcieri's budget would cut Medicaid payments to nursing homes by $45 million (out of $362 million) in this year's budget and $39 million more out of FY09, to save around $40 million in state funds and $44 million in federal funds. In the trade, this is slightly beyond what we call "wildly optimistic." The right way to get these savings is to give people incentives to choose home care over nursing homes in the future. Over time, many people will choose to stay in their homes longer, and the state will (likely) save a bundle. But it's a very different thing to tell a population already ensconced in nursing facilities to go home. Many of them no longer have a home to go to. In a House Finance Committee hearing last week, the administration demonstrated to everyone who was listening that they have no plan at all to achieve these savings, only a theory that they will happen. Somehow. ■

Historic Credit Taxonomy

JUDITH REILLY

Rhode Island has one of the region's most generous commercial historic preservation tax credit programs, at 30% of qualified rehabilitation expenses. The State granted $34 million worth of these credits in 2007, while the appropriations bill currently before the House proposes to cap the actual outlay for tax year 2007 at $20 million in deference to the budget crisis (the cap would rise to $40 million in 2008-2017). Meanwhile, groups such as Providence's Olneyville Neighborhood Association, who have seen the credits used to repurpose mill buildings as high-end residences and retail space, say the tax credits are often used on projects that cause gentrification and displacement. They demand an end to tax credits for projects that will harm existing communities. While the State's previous generosity is under scrutiny, this is the perfect time to examine the illogical disparities between the state tax credits available for commercial properties and those available to homeowner-occupants.

While the commercial program is famous for subsidizing enormous mill conversion projects such as the ALCO development in Providence, both the commercial and homeowner programs affect smaller residences. The homeowner-occupant program covers one- to three-unit houses, and the commercial program is available for rental properties with any number of units.

Both the commercial and homeowner program are meant to encourage historically sensitive maintenance and rehabilitation, thereby enhancing property values and preserving the public's historic and aesthetic heritage. For both programs, the subject property must be listed on a local or federal register of historic buildings or districts, either individually or as a contributing part of a designated district. For both programs, the work done must meet specific standards of historic appropriateness (which are generally not at all onerous).

Here the similarities stop. While the homeowner tax credit is for 20% of qualified rehabilitation expenses (QREs), the commercial credit is 30%. For the homeowner program, QREs are limited to exterior work, while for commercial properties QREs also include interior work such as heating, plumbing, electrical, and other interior improvements. While there is no dollar limit on the total QREs that can be claimed under either program, homeowners are limited to a maximum of $2,000 in credits taken per year (the balance can be carried forward indefinitely). If homeowners cannot use all of their credits personally, they cannot sell them, except by selling the house. A commercial property owner can sell their cred-

Judith Reilly is a grumpy Rhode Island taxpayer and a Providence homeowner who lives in a National Register District. She works in banking and maintains a personal pack of beagles.

its (at a discount of course, but the State foregoes the full face value in revenue). Commercial owners may also be eligible for an additional 20% credit from the federal government, while homeowners are not. The one advantage homeowner-occupants have is that they have to accumulate only $2,000 in QREs in one tax year to apply for a credit, whereas commercial owners must spend at least 50% of the value of the structure to be eligible (though they can phase in a project over more than one year).

Let's imagine two triple-deckers that both need a lot of work. Perhaps they were lost in the foreclosure boom and have been vandalized and stripped of their copper pipes. Their prospective purchasers are happy to learn that both homes are in National Register Districts, and although they are not grand mansions, they are still "historic" for tax credit purposes.

The first house is bought by a real estate developer. Because there is no ceiling on QREs, the developer pours in $300,000 worth of very nice interior and exterior repairs, planning to market the units as higher-end rentals and perhaps sell them as condos after the required five-year waiting period is up. He gets a $90,000 tax credit (30% of $300,000). If he can not use the full credit this year, he can sell it to a third party immediately or carry it forward for 10 years. He may also get another $60,000 federal credit.

The state gets the same benefit from the two credits. Why is one so much more generous?

The second triple-decker is bought by a couple who will live there and use the rental income to help meet their carrying costs. They spend $60,000 on the exterior and $100,000 on the interior to make the house livable, if not luxurious. They can get a tax credit of only $12,000 (20% of the $60,000 spent on the exterior), but they are limited to taking a maximum of $2,000 in any one year. Since the credit is non-refundable, if they earn less than around $62,000, they can not even claim the full $2,000 per year. They cannot sell the credit to anyone else without selling them the house. They get no federal credit.

In each example, Rhode Island taxpayers get a rehabbed triple-decker, but at wildly different costs. Even a strict apples-to-apples comparison shows inconsistency. If a homeowner-occupant and a commercial owner each spend $100,000 on exterior repairs, the former gets a credit for $20,000, while the latter gets $30,000 (as long as the costs exceed 50% of the value of the structure).

It is hard to fathom why the commercial program would be so generous and the homeowner program so comparatively stingy. The 2008 Tax Expenditures Report[1] shows only $254,000 worth of homeowner credits in 2007, compared to $34 million for the commercial credit. One fears that the General Assembly might cancel the homeowners program in an attempt to cut costs. That would be a mistake. Through financial aid to homeowners, the tax credit program does achieve its purpose of encouraging the preservation of Rhode Island's history and beauty, while enhancing property values and shoring up neighborhoods.

The best approach the General Assembly could take would be to examine the commercial and homeowner programs together, and create a more rational joint system. A good chunk of the money earmarked for the commercial program needs to be re-channeled to homeowners, especially in light of the damage being done to historic housing stock because of the recent rash of foreclosures and evictions. ■

[1] Available at *www.tax.state.ri.us*.

Investment Banking: A Sub-Primer

It seems increasingly likely that the real estate crash and the "sub-prime" crisis are going to propel our economy into a recession. The real economic indicators over the past few months are bleak. The stock market remains fairly strong, and this is mystifying to some economists. But in a world with a short supply of productive investments, money will necessarily slosh back and forth between real estate and stocks.[2] The stock market isn't great, but the real estate market is worse. So money remains on Wall Street, propping up sagging values.

But even if the stock market doesn't plunge in a lasting way, these aren't happy times on Wall Street. A couple of weeks back the market averages fell off a cliff on Monday and by late Tuesday had made back almost all the gains lost the day before. Then on Thursday it fell again, and so on. Investors are understandably jittery about the nation's economy (and the world's, since we buy so much from the rest of the world), but they're also nervous about the market itself, and the "sub-prime" crisis has illuminated those issues like never before.

What is the sub-prime crisis? To understand why, first you have to understand how the mortgage market has worked in recent years. The model was this: a bank or a mortgage broker would arrange loans, and then "package" a collection of those loans into what was called a "mortgage-backed security" or "collateralized debt obligation" (CDO). This bond—representing the income to be collected from the various debtors—could then be sold to some investor, and the sale would provide the mortgage broker more money to loan. It sounds like a pretty tidy arrangement, and created a situation where local banks and brokers would have more money to loan than they'd have otherwise.

[2] See **RIPR** issue 25 to understand why this is no big surprise.

But here's the catch: No one will buy your mortgage-backed security without some guarantee that its debtors will pay. And where do you get that guarantee?

Suppose, for a moment that I have made 100 loans, and I'm trying to sell them to you packaged into a CDO. I know that my debtors are a varied lot. There are lots of A+ people—solid finances, solid credit, good risks—but suppose I have around the same number of B's, C's and D's and maybe a few F's. The income from this bond is $1 million a year, but how much will you buy it for?

To answer this means assessing the risk of the investment. Suppose the historical data says only one in 1000 A+ borrowers default, but 1 in 10 D's default. So what's the expected default rate for the whole bond? Well, you could argue that it should just be the average of all the default rates. Or you could argue that the likelihood of everyone defaulting simultaneously is vanishingly small, so the overall default rate is zero, even if a few of the mortgages fail. Or, depending on your debating skills and your command of statistics, you could successfully argue anywhere in between, and that's the problem.

Over the past 20 years, Wall Street has become a major employer of statistical talent, hiring math whizzes from the best universities to puzzle over pricing questions like these. So now put yourself in the shoes of one of those newly-hired whizzes: if you rate the risk high, you're being responsible, but the bond is harder to sell. If you rate the risk low, the price can be high, it will sell, and you will be more likely to get a year-end bonus. Hmmm. Think, think, think. Did I mention that your boss likely won't understand the math behind your decision either way? Did I mention that bonuses even to junior employees at New York investment banks can be in the hundreds of thousands of dollars? With incentives like these, why should anyone be surprised when bond ratings inflate?

And it didn't stop there, either. Other brokers would buy up lots of these mortgage bonds, and package them in a similar way, leaving similar pricing questions to *their* stable of math whizzes. Others would come up with elaborate insurance schemes to buy this set of riskier mortgages, but use this other, supposedly less risky, set to insure them. The variations were endless, but the goal of all of them was essentially the same: to reduce the perception of risk by the buyer. Sometimes this was done by actually reducing the risk, but other times it was only about reducing the perception of risk.

Rule changes

As if the problem of overrating and mystery pricing weren't bad enough, in the middle of all this came some important rule changes. In 2001, at the behest of the bank lobby, Congress passed a bankruptcy "reform" that made it significantly harder for people to declare bankruptcy. Remember that the whole point of bankruptcy is to allow people the time and space to work out their debts (possibly at a discount), instead of defaulting on them. But with that option unavailable, lots of people find it makes the most sense simply to walk away from a debt they can't afford to pay. They'll take a hit on their credit rating, but in many cases, that's still the better choice.

You can see the story in the statistics. The proportion of all mortgages that are 90 days delinquent is a tiny bit under 1%, which is slightly *less* than it was in 1986. But in 1986, this delinquency rate resulted in only half as many foreclosures as in the last quarter of 2006.[a]

What does this mean? Only that when rating agencies and investment banks used historical default rates as the basis for their over-optimistic estimates of risk for mortgage securities, they were using data that underestimated the post-2001 default rates. That many of those same banks were involved in lobbying for these changes in the bankruptcy laws is hard to overlook. The irony would be easier to savor if it didn't seem like we're all on the verge of going down the tubes with them. –TS

[a]See *US Housing Market Conditions*, Department of Housing and Urban Development, Spring 2007, table 18.

Uh-oh So here's the situation: you had mortgage brokers paid on commissions, whose incentives were to sell mortgages, whatever the risk. You had banks relying on the pricing advice of statisticians whose incentives were to over-rate the bonds. You had financial engineers coming up with ever more creative ways to reduce the appearance of risk. The result was investors eager to pony up and borrowers eager to borrow: a real estate market awash in investment funds, especially after the stock mar-

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ket tanked during 2000 and 2001. And surprise, surprise, real estate prices accelerated up. And as all bubbles do, this one popped.

Now we can see the real problem in the investment markets. The popping of the real estate bubble and the resulting wave of foreclosures has made it abundantly clear to even the dimmest investors, that the ratings agencies and investment banks cannot be trusted. Vast sums of bank capital now depend on no one taking a close look at the value of the securities that make up that capital.[3] Were someone to provide a realistic assessment of those bonds, many banks and investment funds would be insolvent right now.[4] Bank of America bought Countrywide Mortgage for around $6 billion, which was exorbitant considering the true value of the company's assets, which are almost all CDOs, but far cheaper than having some bankruptcy proceeding specify the real value of their investment in Countrywide's mortgages.[5]

The debacle is underway, but it isn't because lots of people have defaulted on mortgages they couldn't afford. Maybe that was the trigger, but if a house falls down in a breeze, do you blame the wind or the builder?

George Akerlof won a Nobel Prize in economics in 2001 for the work he did about the effect on markets of asymmetric information. Outlined in his classic 1970 paper, "The Market for Lemons: Quality Uncertainty and the Market Mechanism,"[6] the analysis essentially shows that in a situation where sellers know much more than buyers about the quality of the goods for sale, the market will fail, with quality goods being driven out because sellers can't get a good price—even for high-quality goods. This is exactly what we're seeing now. The market for CDOs has frozen, because nobody knows what's in them. Other markets, like corporate and municipal bonds, are slowing down for the same reasons.

This is all to say that if ever there were an argument for government regulation of markets, this is it. The financial crises of the past few years are the result of unfettered free markets, doing what unfettered free markets do. The 1933 act that established the Securities and Exchange Commission is fairly clear that it's all about "the public interest and the protection of investors" and the phrase occurs throughout the act.[7] Sadly, that's not the current view of its commissioners, who are more concerned about "burdensome regulation" and "nonsensical mandates."[8]

Free market theorists will say that the market is self-correcting, and in a sense they are right. The economic downturn we're experiencing right now, and which is likely to get deeper? That's essentially what they mean by a "self-correction." If you enjoy suffering the real-world manifestation of an economic abstraction, this is your lucky decade.

Unfortunately, while we wait for the market to do its magic, millions of people are going to enjoy a loss of income, foreclosed houses and foregone opportunities. How much better would it be to have a government that would enforce transparency in the first place and skip the whole debacle thing? ■

[3] Complicating the picture is that many of these securities were sold with money-back guarantees in case of fraud. That is, if fraud in the packaging can be proven, many banks will have to buy these bonds back at the original price. Arguments about whether optimism in pricing constitutes fraud are hitting the courtrooms now. Securities law is a growth industry, at least for the next few years.

[4] There are links to some articles about the state of the market in a reference list for **RIPR** issue 30 at *whatcheer.net*.

[5] Plus Bank of America will get to write off Countrywide's massive losses on their taxes over the next few years, sweetening the deal considerably.

[6] *Quarterly Journal of Economics* (3): 488–500, August 1970.

[7] *www.sec.gov/about/laws/sa33.pdf*

[8] See, for example a speech by Commissioner Paul S. Atkins, 22 January 2007, (*http://www.sec.gov/news/speech/2007/spch012207psa.htm*). The thrust of the speech was a call to roll back even more securities regulation than we've already lost.

Look for supporting documents and references, as well as the weekly RIPR column, at *whatcheer.net*.

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