Rhode Island Policy Reporter

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What's in store

WHAT WOULD YOU THINK of someone who tries the same thing fifteen years in a row, and it still doesn't work? What would you call him? Our Governor says, in his budget, that the state is doing all it can, but it can help no more, and that cities and towns simply need to suck it up and cut their wasteful ways. This is, of course, the same message he delivered last year, and the year before. It's the same message that Lincoln Almond delivered for the eight years before that, and Bruce Sundlun had the same routine down pat for the previous four. Each of these Governors promised to hold the line on expenses, and not raise taxes. And each presided over huge property-tax increases, growing state expenses and increasing state indebtedness.

It's easy to blame the legislature for this, but it's pretty rare for the General Assembly to rewrite a budget from scratch. Generally speaking, the budget they pass follows the outline of the budget they're given. They edit and shift things around, but when was the last time you heard of the legislature making big changes to what they were presented, such as creating a new department, or adding a new tax?

You might also blame the towns for their profligate ways, and that's the route the Governor usually takes these days. But it's hard to shake the impression that the Governor hasn't witnessed a lot of town council meetings. During Ed DiPrete's term as governor, the state pledged to fund 60% of school costs for all municipalities, and was each year inching closer to that goal. (He had been, after all, the Mayor of one of our cities.) Now, school committees around the state would be overjoyed to see a return to 50%. The Governor says the situation is because municipal budgets are out of control, and the state can't afford to do anything about it. But if the problem is just fiscal discipline, wouldn't the laws of probability demand that at least one town somewhere was not hurting? Where is it?

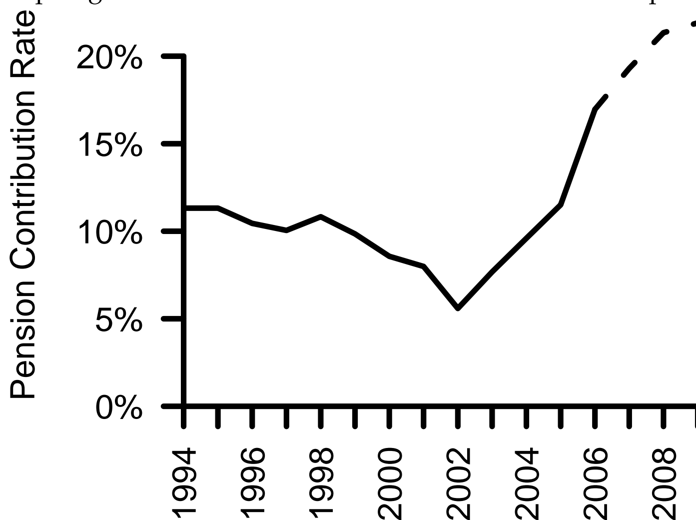

Figure 1: Employer contribution rates to the pension system for state employees. They're up quite a lot and headed higher. The employer contributions for teachers shows a roughly comparable story. The rate declined substantially during the good investment years of the 1990s, but shot up recently, nearly tripling since 2002, with more increases on the way. Much of the blame goes to the recession, but this isn't the only reason. See page 2 for more.

If the problem were just fiscal discipline, wouldn't we expect that at least one town somewhere was not hurting?

Town councils and school committees are a lot of things. Some are pretty weird, with miniature Napoleons attempting to exercise control over their petty kingdoms. Others are marked by the sort of chaos more often associated with a flock of seagulls. Others work better. They are a varied lot, with no two alike. But trying to brand them as uniformly "spendthrift" seems like a stretch. People don't get elected to town councils by promising to spend more. They get elected by promising to be good stewards of the town's resources, and by being good to their neighbors. According to the Governor's story, taking the oath of office somehow transmogrifies these sensible stewards into drunken sailors. And it apparently happens to all of them. How does this work?

I watched some steps in the process in my town a few weeks ago. The new council (three new members out of five) was ready to step up to the plate and put the brakes on spending. "Let's talk about outsourcing," said one. "Alliances with neighboring towns to make regional purchases," cried another, while a third mentioned "zero-based budgeting." The town manager replied, well, did you notice that your property tax bills are postmarked from Ohio? We outsourced that a few years ago. School buses, too. And we do purchase school supplies and office supplies through the state master bid. But if there are other things we haven't already looked at, let's do that. And we did a zero-based budget just a couple of years back, and it didn't save a lot of money, and did take a great deal of department directors' time. The restive members of the council settled back down in their seats and looked glum.

Most towns and schools are run by people whose job it is to run them. They tend to care about the towns in which they live, often pay property taxes in those towns, and receive pats on the back for finding cost savings. What makes us think that they haven't been looking for ways to save money? It's beyond doubt that our towns

harbor occasional incompetents and malefactors. What enterprise doesn't? But to imagine that government in 21st century Rhode Island is a plush enterprise is to deny the evidence of one's senses, and go with what seems to be the prevailing view: rising taxes mean a government administered by idiots.

What if we were to assume, for the sake of argument, that the people who run our towns and schools see the same newspaper articles about outsourcing, read the same books about business strategies and watch the same news programs about property tax riots in Cranston? In other words, what if we were to assume that the important issues in town governance are not ignorance, but perhaps something else? In that case, we could try to understand the situation instead of simply railing about it.

RIPR and the Governor share some of the same goals: efficient public service, delivered at the lowest cost possible. But the important question that seems never to be asked is, how do you do that? Is the Governor's strategy the best one, or will it always fail? Some evidence is available.

It's easy to find villains to blame when a political strategy fails. What's harder is to find a compelling reason why a failed strategy should be tried again. Absent that compelling reason, trying again is only a symptom of a lack of imagination, or worse. As of 2005, Rhode Island's Governors have tried the strategy of demanding "responsibility" from towns, slashing their allocation of state budget funds, ruthless cutting of state services, and refusing to use state power to defuse property tax increases. It's the obvious thing to do. But after seeing the same strategy tried fifteen years in a row, and failing year after year, I wish for a Governor who would think of a new strategy. ■

Penchant for pensions

While reading the state budget for fiscal year 2006, it's impossible to overlook the massive increases in pension costs. Nor is it possible to ignore the moaning that seems to emanate from town halls and school administration buildings all over the state. The money the state spends on pensions for its employees is scheduled to jump from $94 million to around $140 million — a 47% jump in less than a year.[1] What's more, the Employee Retirement System warns that next year will be just as bad. (There's a picture on page 1.) The story is pretty much the same for all the school systems in the state, whose teachers are part of the same system.

Pension contributions are treated like a force of nature, but there are people behind them.

The pension contributions are treated as a given, and their increases like a force of nature. But in fact, the pension contribution formula is determined by people, just like everything else in the budget, and their assumptions and methods are worth examining, too. **RIPR**'s examination has shown that there is some slack in the pension contributions, and that the performance of the stock market over the past few years is only part of the story. To understand where we are and how we got there, some background is needed.

To start with, ERS runs not one, but several pension systems. One system is for all the state employees and all the teachers. The employees contribute a set amount of their paychecks (8.75% for state employees, 9.5% for teachers).[2] The state also contributes on behalf of its employees and the towns and the state split the contribution for teachers 60/40, with the towns paying the bigger share. The pension system for municipal employees is a separate thing. These are run as many small separate systems, but the investments are pooled and managed together. Finally the state police and judges each have their own pension systems, much smaller than either of the others.

The investments for all these pension systems are managed together, so that each plan will see the same investment returns, but their contributions and expenses are accounted for separately.

How did we get here? The ten-cent answer is that the stock market had a couple of horrible years. It's starting to turn around, but pension plans calculate investment returns by averaging over a five-year period. This means that the investment performance for next year will still be bad, because the five-year window will still include the terrible years and will no longer reach back to the good years before 2001.

But the state is not blameless, either. The early retirement schemes of the early 1990's, and the pension pay-

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[1] See [P I-10]. (That's a budget page number.)

[2] It's worth an aside here to note that, according to actuaries at the Segal Company, an employee-benefit consulting company, and at the American Academy of Actuaries, very few private pension plans require employee contributions at all. When making salary and pension comparisons between the private and public sectors, it's an important consideration that the pension contributions by state employees and teachers are almost 10% of their salary.

Unfunded liability

The two magic numbers for any pension plan are the amount it owes and the amount that it has to pay those debts. The essential accounting problem is that the money a system owes won't be payable for a number of years, so you can't really compare it to the money you have on hand right now. So pension systems hire actuaries, whose job it is to make a pile of reasonable assumptions — about investment returns, the rates at which workers retire, the rates at which retirees die and so on — and calculate the future liabilities of the system, and attempt to figure out how much money you need now to pay that money in the future. The difference between that money and the money actually on hand is called the "unfunded liability" of the system. The ratio between the two is the "funding ratio." A system with zero unfunded liability has a funding ratio of 100%, which means it has exactly enough money to pay all the future liabilities, as of right now. A system at 110% has more than it needs to pay its retirees, and a system at 90% has less than enough.

So the next question is what is the unfunded liability of the RI ERS systems? The state system, as of the end of the 2003 fiscal year (the most recent one with audited numbers) reported an unfunded liability of $1.194 billion for state employees and $1.857 billion for teachers. Given the plans' assets of $5.7 billion, this is a funding ratio of around 65%, down substantially from closer to 80% a few years ago.[a] The municipal pensions are doing better collectively (no one lets them skip payments, like the state has, and they haven't suffered massive early retirement scams) and are funded at around 100%, although this hides a range of values, from East Providence at 77% to Barrington at 255%.[b]

[a]Data from the draft ERSRI Evaluation Report of the Governor's Pension Review Team. July 2004, see pages 42 and 48.

[b]This is from the 2003 ERS annual report, so would be 2002 numbers. Both have probably declined since then.

ments skipped or reduced under the Sundlun administration were collectively worth around $300 million in reduced funding, according to Governor Carcieri's pension review commission, or around 10% of the entire system's current "unfunded liability."[3] (See box.)

Obviously, we can't take back those actions, but it is important to realize that the state bears a substantial part of the responsibility for the current crisis. Since the Governor is asking towns to suck it up and cut their budgets in the face of huge pension cost increases, the question of how we got where we are is not purely of academic interest.

Where are we going? Once your actuaries have computed the unfunded liability of a pension system, the next obvious question is what do you do about it? For a private pension system, the choice is obvious, because there are laws that say what must be done. For a public system, the choices aren't so clear.

Pension systems operated by a private company are usually guaranteed by the federal government, appearing in the guise of the Pension Benefit Guaranty Corporation (PBGC). In order to keep this insurance in effect, the PBGC requires a private pension system to keep as small an unfunded liability as possible, since there is always the chance that the company may go out of business. Therefore a company that reports an unfunded liability is required to build up its pension fund until it goes away. In accountant-speak, this is amortizing the liability.

A public pension system operates under very different conditions. For one thing, a government isn't at risk of going out of business. Governments are meant to be permanent. Even a government that suffers some kind of bankruptcy will still exist after the dust settles. Because of this, substantial philosophical differences exist among actuaries and pension experts about how best to analyze the funding requirements of public pensions. Some of the arguments about Social Security are over related issues.[4] For example, should unfunded liabilities be amortized over ten years? 30? 75? Infinity? Does it even matter if they are amortized at all, so long as the system keeps paying? There is no "correct" answer to these questions. The goal is only to keep the system paying what it owes, and the rest constitutes only guidelines to making that happen with minimum pain.

Into this philosophical mire has waded the Government Accounting Standards Board (GASB), who sets various standards so that accountants don't have to make decisions when they do their audits. GASB has decreed that 30 years seems like a fine number, and so actuaries and accountants across the country follow suit. This is a fairly arbitrary number, even if it has a pleasing symmetry with the number of years most people work, but nonetheless, pension systems that don't conform are given the hairy eyeball by the gods of finance who dictate bond ratings. States that care about their bond ratings[5] don't want to

Public and private pension systems are different because governments don't go out of business.

[3]Pension review team draft report, p.23.

[4]Though there is also some outright dishonesty afoot in that debate. The trust fund is not "imaginary," for example, and the system will not be "bankrupt" when the trust fund is exhausted. These are not evidence of philosophical differences, but evidence of sophistry designed to confuse voters. **RIPR** issue 8 contained an attempt at bringing some clarity to the situation. See *whatcheer.net* for back issues.

[5]And Rhode Island certainly does, since borrowing oodles annually is official state policy. See **RIPR** issue 7, about borrowing at DOT.

run afoul of GASB rules.

Somewhat unusually among states, Rhode Island has encoded into its general laws the rules to be used by the pension board for amortizing its liability.[6] It is written there that the state must use 30 years to amortize its liability, in accordance with GASB standards. But here's a new philosophical issue: for a permanent enterprise, where should that 30 years start, and where should it end?

To amortize their liability, a public pension system can choose two models. A "closed" system specifies the start date of the amortization period, and has a specific end date. According to the director of the ERS, the RI pension oversight board chose this model in 1999, and is on a schedule to pay it off by 2029. Alternatively, an "open" system declares that every year is year one of 30, and makes a payment accordingly. At first glance, a closed system seems more fiscally responsible, more hard-nosed, but there are perfectly valid reasons to prefer the open system which, after all, still makes progress toward retiring the liability. For one thing, the unfunded liability is recalculated every year. This means that, should the actuaries be wrong about something, you can always amortize the consequences over 30 years. In a closed system, you may have fewer than 30 years left in the term, and can only amortize the error over the remaining years.

To illustrate with an example, consider Rhode Island. We started a closed term in 1999, but in 2001, the stock market tanked. This was not predicted by our actuaries, and the unfunded liability grew. At first it didn't matter much, since investment returns are calculated with a five-year average. But as the stock market slump continued, it started to matter. You can see this in the graph on page 1. Now, five years into the closed term, we have a $3 billion unfunded liability, and only 25 years left. That's a lot of money, and so it matters a great deal whether we amortize that amount over 25 years or 30. The difference in payments is around $20 million per year. In other words, the state is paying $12.5 million and the towns are paying $7.5 million more per year in order to seem more fiscally responsible than anyone requires us to be.

We are paying more than we need to in order to seem more fiscally responsible than anyone requires us to be.

But isn't it better to pay off the liability on a set schedule? Won't we reap the benefits of lower pension costs when we do? The answer is "Yes, but..." The question betrays a misunderstanding of how actuaries work. Even amortizations proceeding on a closed term never get to year 30. The problem is exactly the one illustrated here. When the term gets too short, or the actuarial assumptions too far off, the result is dramatic increases in pension contributions, and no one wants that. One actuary I spoke with said she never lets plans get beyond around year 18 on the schedule before recommending that they start again at 30.[7]

According to Jerome Williams, the Governor's pension point man, the pension review committee specifically decided *not* to examine the accounting issues involved in pension payments, and only to consider reforms based on restricting pension benefits. The committee itself was split 6-6, and unable to make any recommendations as a body, but the Governor has introduced some pension modifications with his budget. Specifically, he proposes slowing the benefit accrual rate, raising the eligibility age and lowering cost of living adjustments.[8] The changes are fairly modest for people with fewer than 20 years of service (1-2% benefit cuts), and for people with 38 years (the maximum). But for people with who've worked for the state between 25 and 35 years, the changes would amount to cuts of 10-13% in their pension. These reforms would lower the cost to the state by around $25 million next year, and about $18 million for towns. [ES18]

The state has a choice in how aggressive to be in amortizing the unfunded liability.

The decision to use a closed amortization schedule was made in 2001, before the stock-market slump. The decision to stick with that aggressive repayment schedule in the face of the stock market returns over the past couple of years was a choice with important consequences for the state budget, and for all the municipal school budgets. There is an argument that it is still the right choice, but there are opposing arguments, too. At any rate, the state has this choice, and it shouldn't go unexamined. ■

Taxes

Word has reached **RIPR** HQ that the Governor of Connecticut has told the state legislature that prudence demands that some taxes be increased to pay for roads. She offers her state a choice: if you want better roads, pay for them. In the impossible political climate of today, this may be a suicidal move, but principled stands sometimes are. It makes them no less commendable.

In contrast, it is a foregone conclusion that taxes will go up this year for the vast bulk of Rhode Islanders, but the

[6]R.I.G.L. 36-10, last changed in 2001, in P.L.77, article 18 (the FY02 budget).

[7]We could have almost the same savings just by restarting the clock this year, so the debate doesn't have to be between open and closed. It's really between doing nothing and doing something.

[8]The COLA change proposal is to make it track inflation instead of being a fixed 3% hike each year. But the Governor wants it both ways: he only wants to track inflation when inflation is *less* than 3%.

Governor won't go near the issue.. But whether he will or won't is almost beside the point, the only important question is whether the taxes that go up will be state taxes or property taxes.

It is said to be common knowledge that Rhode Island taxes are too high. But too high for whom? The fact is that state taxes on low- and middle-income Rhode Islanders are nowhere near the top of the range among states. For the wealthy, income taxes are high here, but the sales tax is a bargain — there are places in at least 27 other states where sales taxes are higher. (**RIPR** issues 2 and 4 contain much more about the actual levels of taxes in Rhode Island.) What is a problem is property taxes. Rising property taxes are exacerbating our housing crisis and decimating our communities. And yet offical state policy over the past 15 years has essentially guaranteed that they will continue to rise, by a lot.

In the hope that at some point reason will prevail, here are some alternative tax proposals that might be used to take some of the pressure off property taxes.

Old advice

The silver lining to having your advice ignored is that you're free to offer it again the next year — **RIPR** is a true believer in recycling. **RIPR** issues 1, 4 and 7 contain plenty of suggestions about overspending and unwise spending in state government, all still valid, some more so. (Other issues detail underspending, but no one seems to care about that this year.) Those issues describe departmental duplication, state-paid lobbyists, out-of-control borrowing, and more. All the back issues are available at *whatcheer.net*. Read them and then subscribe. You'll get the issues in a more timely and reliable way, and you'll get the satisfaction of helping to rationalize what passes for policy debate here in Rhode Island. $35/11 issues, address on page 2, or pay online with a couple of clicks. –TS

Income tax alternatives

In 1996, Governor Almond engineered a 10% income tax cut, spread out over 5 years. It was a meaningless cut. Most people I talk to aren't even aware they got it, and small wonder: most people pay many times as much in property tax as they do in state income tax.

Should the state decide to go back to the bad old days of 1996, it could realize around $100 million in income, and few would notice on their tax bills. (They'd notice the talk radio screamers, but the screamers are going to scream anyway, about whichever tax goes up.)

If you could wave a wand and apply all that revenue to property tax relief, over 90% of the state would see a decline in their taxes. Were you to double the income tax and apply that all to property taxes, more than two-thirds of the state would see relief, many in the thousands of dollars, and many of those seniors.

Admittedly, these kinds of reforms would require a magic wand. There are many institutional obstacles, including starving towns and landlords between the state and the towns' property taxpayers. But this illustrates an important point: the best way to achieve property tax relief is to prevent those taxes from going up in the first place.

Sales tax alternatives

It is often said that Rhode Island's sales tax is among the highest in the country. But the people who spread such rubbish haven't done much travelling. Rhode Island (and the rest of New England) doesn't have much in the way of county government. But in the rest of the country, this is the norm. In most states, the state levies some taxes, and counties levy some, too. In many states, they both levy sales taxes (and lots of big cities have them, too) and so you pay sales taxes quite a bit higher than ours in at least 27 states.

In a stable real estate market, it's not perfectly clear whether sales taxes are more or less regressive than property taxes. But in the real estate market we've been suffering under for the past few years, it's quite clear. Because of the market insanity, it is no longer true that the value of your house bears any sensible relation to your income. People with high incomes and low both live in expensive houses. The important variable is how long they've been there, not how much they earn.

The sales tax currently earns $906 million. A hike in sales taxes from the current 7% to 7.5% would earn about $60 million. It's not proportional, since presumably some sales would be lost to Massachusetts and Connecticut.

There have also been, over the years, a variety of proposals to broaden the sales tax, and begin to tax formerly untaxed transactions. It's possible to craft such proposals that make the sales tax either more or less regressive. For example, taxing clothing might make the tax weigh more heavily on the poor than on the wealthy, but taxing only clothing worth more than $500 might do the opposite. Past proposals have also included taxing services, which makes a certain amount of sense in an economy tending toward that sector, but again, "services" can cover swimming-pool cleaners, lawyers, TV ad production and day-care providers, so the devil is in the details.

Other tax alternatives

Here are a few miscellaneous tax proposals that would serve the public and raise money, too. Among them is a set of corporate tax loopholes that have needed closing for years, as well as some less popular proposals that might still be a good idea.

Mortgage interest deduction Ending the mortgage in-

terest tax deduction on state income taxes would increase the progressivity of that tax, and would raise around $4.5 million. It might have a serious effect on real estate sales, but cooling off the housing market would be a good thing for almost everyone, homeowners included.

Realty transfer tax This was proposed years ago as a way to fund the still-empty housing and open space trust fund, an attempt to fund open space purchases without increasing state borrowing. At this point, open space and housing needs might be best served by tamping down the real estate market, and a tax like this could serve that purpose even if its proceeds weren't dedicated to purchases. Around $4.5 billion of residential real estate was sold last year[9] Adding a tax of $1/$1,000 would raise around $4.5 million, assuming the market doesn't grow at all. There aren't as good public numbers for the commercial real estate market, but reasonable estimates put it at around 10% the size of the residential market. Another proposal that's been around is to tax only the residential properties above the median at a higher rate. Adding $2/$1,000 to the tax on those properties would raise around $7 million.

Realty capital gains tax This anti-speculator tax would apply to capital gains from real estate sales, and it would be graduated like the similar tax in Vermont, so that the longer you keep the property, the lower the tax. A graduated tax that ranges from 50% for properties kept a year or less to zero for properties kept more than six years could raise as much as $8 million, though a better (and more likely) result would be to raise much less, and tamp down speculation in real estate.

[9] MLS data, see *riliving.com/oceanstate/SalesStats/*

Withholding from S Corps and Partnerships Out-of-state owners of Rhode Island S Corporations and Partnerships are supposed to pay Rhode Island income tax on the partnership's earnings. But there is no requirement that the corporation withhold those taxes, so it's on the honor system.

Close the PIC loophole A "passive investment company" can be used to avoid substantial RI Business Income Taxes. The way this works is that a business here would claim that some PIC incorporated in Delaware (or Switzerland or the Cayman Islands) owns the intellectual property rights to its product or its logo or name, and that it must pay a licensing fee to the PIC. This can soak up all the income from the local business, and move it to some lower-tax location. As of 2003, thirty-one states have acted to close this kind of loophole, and RI should do so as well.

Establish a "Throwback" Rule The federal rules that define what part of a corporation's income comes from which states often leaves income allocated to a state in which a corporation has no presence. This in turn means the company cannot be taxed on that income — by any state. Rhode Island should establish a "throwback" rule to apply to corporations based here that would require that income not taxed by other states should be taxed here. As of 2003, twenty-five states with corporate income taxes have this rule.

Two-year-old estimates from the Center on Budget and Policy Priorities are that Rhode Island could realize as much as $8 million in revenue by closing the last two corporate tax loopholes, and by modifying our business income definition, which does not reflect a number of Supreme Court decisions. A throwback rule in place will help us to comply with these decisions. ■

The RIPR blog
is going strong!
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