



A PROPOSAL TO FINANCE A FULL SCALE MODERNIZATION OF BALTIMORE CITY PUBLIC SCHOOL FACILITIES

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David McNear brings more than 15 years experience working to increase funding for children services. Under contract to Maryland's Advocates for Children and Youth (ACY), Mr. McNear continues to run the Sustainable Funding Project, a child-focused budget analysis and advocacy project. He also has consulted with Baltimore's Safe and Sound Campaign, Maryland Budget and Tax Policy Institute, Innovations Institute, Voices for America's Children, and Florida Children's Campaign. Before relocating to Florida, David served as the Sustainable Funding Director at ACY.

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About the Maryland Budget and Tax Policy Institute

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The Maryland Budget and Tax Policy Institute is a nonpartisan research organization that provides timely, accurate and accessible analysis of state budget and tax issues. In addition to general budget and tax research and analysis, the Institute examines issues affecting low-income Marylanders and other vulnerable populations and the important community programs that serve them. The Institute is a project of Maryland Nonprofits, www.mdnonprofits.org. National and local foundations, individual contributions and Maryland Nonprofits fund its work. For additional information, to be added to our e-mail list, or to make a tax-deductible contribution, please visit our website at www.marylandpolicy.org.

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Executive Summary

The ACLU of Maryland Foundation's recent report, "Buildings for Academic Excellence: A Vision and Options to Address Deficient School Facilities in Baltimore City," shows the urgent need for upgrades or replacement of 70% of Baltimore City Schools' buildings. This program's cost is estimated at \$2.8 billion.

This ACLU report shows that the current funding system is wholly inadequate to bring city school buildings to healthy and educationally appropriate standards. However, there are innovative financing strategies that could comprehensively and feasibly address the \$2.8 billion need. Increasingly, innovative financing is being used by jurisdictions to solve infrastructure problems. The ACLU presented one of these financing models used by Greenville, South Carolina, which allowed for a complete modernization of the county's schools in a timely and adequate way.

The Maryland Budget and Tax Policy Institute is proposing a similar financing model for Baltimore City, which involves a partnership organization that would issue bonds and manage the \$2.8 billion school construction program to be completed over 10 years. The partnership could be a government agency, an independent public authority, or a state-chartered nonprofit organization.

The debt would be repaid over 30 years through a combination of the following sources:

- Direct lease payments to the partnership by the State of Maryland and the City of Baltimore.
- Proceeds from two new local revenue measures:
 - A 1% local sales tax
 - A 1% tax on meals and beverages sold within the city.
- A share of impact aid paid to Baltimore City from proceeds of video lottery terminal (slot machine operation).

The state would increase its current contribution to Baltimore City school infrastructure to total \$100 million in annual payments towards debt service over the first 10 years, and \$50 million for the remaining 20 years. The city's revenue streams would generate an average of \$165 million per year towards the school construction program over 30 years. The financing strategy also allows for inflationary increases over the lease period and a sound income-to-debt ratio each year for security on the debt payments.

To implement a sales tax and meals and beverages tax of 1%, the City would need state authorizing legislation. These revenue sources illustrate just one potential financing plan. There are many other revenue options available. Most require legislative approval at the city and state levels.

The modernization of Baltimore City Public School facilities is needed to achieve Maryland's Constitutional standards for a "thorough and efficient" education. It is needed to provide thousands of Baltimore City students with their chance for a successful life as independent, productive adult citizens. And it will provide substantial economic benefits for the city and its neighborhoods.

The expense of fixing the school buildings is substantial. The cost of prolonging their neglected condition is much greater still.

Review of “Buildings for Academic Excellence”

In June 2010, the ACLU of Maryland Foundation published “Buildings for Academic Excellence: A Vision and Options to Address Deficient School Facilities in Baltimore City.” The report shows that approximately 70% of Baltimore City school facilities are in poor condition, which has severe educational, health, and economic impact they have on student and teachers.

The quality of school facilities measurably affects academic performance and the overall success of teachers and students. Poor temperature control caused by deficient heating and cooling systems has the biggest impact on student achievement. Poor lighting and uncontrollable noise impair learning, and student achievement suffers in high schools without adequate science labs. Deficient school facilities have also been correlated with low attendance, high dropout rates, and a lower rate of attracting and retaining high quality teachers. Further, outmoded facilities contain hazards such as indoor air pollutants and lead in the water, which poses a threat to the health and safety of city students and teachers.

On the contrary, modern school facilities in Baltimore City would improve student outcomes and have benefits beyond the classroom. New and renovated schools would help to revitalize neighborhoods, retain middle class families, and create many new jobs in construction and related industries.

While the city and the state have increased school construction funding over recent years, Baltimore’s school buildings have been neglected for so long that any ordinary funding plan will barely make a dent in the overall needs. At current levels of state and city funding, it will take 50 years to bring city school buildings to modern standards. By that time, the schools’ condition will have deteriorated again.

The ACLU’s report highlighted innovative financing models that other states and districts have used to comprehensively address their school infrastructure needs, within a short time period. If Baltimore City Public Schools could rebuild its facilities in 10 years, the construction contracts and jobs would help the city’s economy. As long as the economic recovery is weak and slow, the city will get good deals on school construction. Construction bids and interest rates are both low. In addition, millions will be saved by lower utility costs with new and efficient systems and by avoiding the projected cost of inflation over five decades.

In the longer term, a school renewal program would be an investment in the city’s economic health, as well as in the future of the students. Incremental improvement, however, will not make enough of a difference. Baltimore’s situation calls for a large, dramatic and expedited building program.

Since public education is the state’s Constitutional responsibility, the state needs to contribute to this effort. But, the City cannot absolve itself of any cost to meeting this need. A significant city contribution will be needed to leverage state resources. And we will need to be creative in constructively involving the business and nonprofit communities in the effort.

This report suggests one model for financing the needed improvements with the required urgency.

Key Principles to Guide the Development of a School Modernization Plan

Implementing a mass-scale school construction program is complicated and there are many different approaches that can be employed. Regardless of the approach selected, there are key principles that should guide the development of a comprehensive financing plan.

- A. **Urgency** – The condition of schools in Baltimore City constitutes a crisis. Every school day that inadequate facilities persist diminishes children’s potential for success. If Baltimore suffered a natural disaster that destroyed 70% of its school buildings, the City and State would find a way to make decent facilities available. The current situation is similar, but it does not seem so urgent because the damage occurred over the course of decades instead of hours. Nevertheless, our response should be the same. Funding must be available as promptly as possible - over the course of a few years, not decades. A timely response to this crisis yields ancillary benefits as well. The city can take advantage of low interest rates, and avoid future inflation increases in the cost of construction. Construction expenditures now can help the city’s economy at a time of high unemployment.
- B. **Fiscal security** – The plan must have adequate identified funding sources and security mechanisms to protect taxpayers and assure the ability to repay debt, making the projects a safe investment.
- C. **Capacity** – Administering \$2.8 billion in a construction program is a full-time, long-term job for a team of professionals. Neither Baltimore Public City Schools, the City, nor the State have the capacity to manage this task properly, in addition to their existing workloads. A temporary dedicated partnership will be needed to devote the proper attention and expertise to reconstructing the city’s schools.
- D. **Sustainability** – The project must be assured of continued support from the school system and city and state administrations throughout the construction and payback periods.
- E. **Resilience** – The project must have the flexibility to adjust to changes in financial and economic conditions as well as to meet changing needs and priorities.
- F. **Transparency and Accountability** – The business operations related to the financing and construction programs must be open and public. The program must measure and report on its progress and quality. The program must have effective, modern mechanisms for seeking, accepting and responding to public input. Appropriate officials of the school system and city and state governments, and representatives of the affected communities must have roles in decision-making, and oversight of the program.
- G. **Workforce and Business Development** – The construction program should have skill training and workforce development components, so that local residents can benefit from opportunities to gain skills and get jobs. There should also be strong efforts to leverage the projects to help develop local and minority business opportunities.

MBTPI Proposal to Finance “Buildings for Academic Excellence”

The goal of this financing model is to complete the school construction program within ten years. There are many possible ways to accomplish this objective. This proposal illustrates one possible approach to

show that a 10-year, 2.8 billion financing program to meet this severe need is within reach. It can be done.

Partnership Organization

The state and city should designate a **Partnership organization** to borrow the funds and manage the financing and construction of the building program. The organization could be a government authority or a state-chartered nonprofit organization. In this report, we do not recommend a specific organizational format for this entity, and we refer to it as the “Partnership organization.” To accomplish the goals of the program, the partnership organization will need the following powers and functions.

- Authorized to borrow funds by issuing bonds and repay them over 30 years.
- Authorized to assume ownership or long-term lease rights to city-owned land and buildings.
- Oversight from representatives of state government, city government, Baltimore City Public Schools, parents, teachers and taxpayers.

The Partner organization must have competitive, accountable, and transparent processes for issuing debt, contracting for services, and buying, selling, and leasing properties. The Partnership organization would take ownership, or long-term leasing rights, to the facilities it builds and renovates. At the conclusion of the repayment period, full ownership will revert to the city government.

Security for Debt

In order to borrow funds at reasonable rates, the organization will need resources and legal authority to provide investors with sound security that the principal and interest will be paid on schedule.

- Contract or lease with the city for a dedicated stream of revenue as lease payments over 30 years
- Contract or lease with the state for a guaranteed stream of lease payments over 30 years.
- The Partnership organization will maintain a year-end fund balance at least equal to the following year’s debt service.
- The Partnership organization’s estimated revenues will be 50% above the amount needed to meet debt service (1.5-to-1 “coverage ratio”).
- The revenues beyond those needed for debt service, the fund balance, and the partnership organization’s administrative operations will be used for pay-as-you-go funding for construction, reducing the amount of borrowing that would otherwise be required.
- If necessary, the Partnership organization may pledge the land and buildings (or long-term leasing rights to them) as security for the repayment of funds.
- If necessary, the Partnership organization may purchase insurance to improve the marketability of the debt.

Partnership Organization Models

The organizational structure of the Partnership organization is important to provide professional management, financial soundness, and public accountability. In addition, the structure of the

organization and the make-up of the governing board are important to achieving broad public and political support for the project.

There are a number of possible legal and organizational models for the Partnership.

1. **State Agency.** The Partnership organization could be an independent state agency with authority to issue revenue bonds, similar to the Departments of Transportation, Housing and Community Development, and Environment.
2. **Financing Authority.** The Partnership organization could be an independent authority that could issue revenue bonds, such as the Maryland Stadium Authority.
3. **State-Chartered Corporation.** The Partnership organization could be a corporation chartered in state law, such as the Maryland Economic Development Corporation (MEDCO).
4. **Non-profit Organization.** The Partnership organization could be a non-profit organization, such as the one established in Greenville, South Carolina (referenced in ACLU's report, *Buildings for Academic Excellence*).

Whatever the legal form, the partnership should have a governing board that fairly represents all the major stakeholders in the project. Seats would be appointed by the Governor of Maryland, the Mayor of Baltimore City, the State Superintendent of Schools, and the CEO of Baltimore City Public Schools. There should also be representatives from other important stakeholders on the board, including: teachers, parents, students, the financial community, and Baltimore employers.

The partnership also must have the ability, resource, and flexibility to obtain the management staff and expert advisors it needs to carry out this ambitious and complex project. It must be able to hire and contract for well-qualified managers and experts in finance and project management.

The Construction Plan

For purposes of this study, the entire construction plan is scheduled over 10 years, 2013 through 2022. We assume that expenditures will be concentrated in the middle four years of this period, with ½ of the total to be expended from 2016 through 2019. The other half of the costs is evenly split between the first three years and last three years of the period.

Pro-forma Construction Cost Schedule (Dollars in Millions)

Fiscal Year	Construction cost <i>2011 dollars</i>	Inflation factor <i>2011 = 100</i>	Construction cost <i>nominal dollars</i>
FY 2013	\$233 m	106.1%	\$248 m
FY 2014	233 m	109.3%	255 m
FY 2015	233 m	112.6%	263 m
FY 2016	350 m	115.9%	406 m
FY 2017	350 m	119.4%	418 m
FY 2018	350 m	123.0%	430 m
FY 2019	350 m	126.7%	443 m
FY 2020	233 m	130.5%	304 m
FY 2021	233 m	134.4%	314 m
FY 2022	233 m	138.4%	323 m
Total	\$2,800 m		\$3,404

The schedule assumes 3% annual increases in construction and related costs. Over the 10-years of the construction phase, this increases the funding need to \$3.4 billion.

The Financing Plan

The Partnership organization would assume title or gain a long-term lease interest in the properties to be replaced. It would borrow \$2.05 billion in 2013, to be paid back over 30 years. Most state and city school construction debt is repaid over 15 years. However, given the magnitude and urgency of the need in Baltimore City and the long useful life of school buildings, it is reasonable to provide – on a one-time basis – a 30-year repayment period for this project. The 30-year repayment period will reduce the annual debt service requirements.

Over the ten years 2013-2022, the Partnership would also expend \$0.75 billion in pay-as-you-go capital funding. Since the Partnership would maintain a fund balance during the construction period, it would earn over \$0.6 billion in interest. These three sources make up the total \$3.4 billion (after inflation) construction program.

Beginning in 2023, the Partnership would dedicate \$90 million for capital maintenance of the buildings after construction. This could include upgrades and replacement of electrical, plumbing, climate control, roofs and other major building components, as needed. This approximates 2.5% of the construction cost of the facilities. This amount would increase with inflation over the life of the Partnership.

At the conclusion of the 30-year repayment period, the ownership of the facilities would return to the Mayor and City Council of Baltimore.

The fund balance and any residual assets of the partnership would become property of the Baltimore City Public Schools.

Construction Fund Sources

Partnership Debt Financing	\$2.05 billion
Pay-as-you-go Financing (5 years @ \$50 million/year and 5 years @ \$100/year)	\$0.75 billion
Interest earnings on bond proceeds*	\$0.60 billion
Total	\$3.40 billion

* Interest earnings must be restricted to the interest rate on debt service to avoid arbitrage restrictions.

Proposed Funding Sources

Additional funding sources will be needed to repay the debt incurred for the program. This report includes one possible set of revenues to finance debt service on the \$2.05 billion needed for this proposal. There are a wide variety of possible revenue sources available to the city – many requiring state legislative authorization or other external approvals. This funding plan is intended as an illustration to demonstrate that, though not easy, the funding needed to meet the need is within reach.

Based on an interest rate of 5%, annual debt service on \$2.05 billion over thirty years is approximately \$133 million. To provide greater security to investors, we are proposing that revenues dedicated to the project should total 50% more than the debt service, providing a 1.5-to-1 “coverage ratio,” and \$2 million to cover estimated annual administrative costs.

The minimum amount of revenue required would be \$200 million annually. Additional funding is recommended to establish reserves to assure that at the end of each year, the Partnership organization has enough funds to meet the following year’s debt service.

Pro-Forma Partnership Income Statement

During 10-year Construction Phase 2013-22

Dollars in Millions – Figures Represent 10-Year Average

Sources		Uses	
State Payment	\$100 m	Debt service	\$120 m
City		PAYGO funding	\$75 m
City Payment	\$18 m	Administration	\$2 m
Local Sales Tax	\$77 m		
Meal & Beverage Tax	\$13 m		
Share VLT Revenue	\$17 m		
Interest on fund balance	\$21 m	Transfer to fund balance	\$49 m
TOTAL SOURCES	\$246 m	TOTAL USES	\$246 m

Pro Forma Partnership Income Statement
During 20-Year Repayment Phase 2023-42

Dollars in Millions – Figures Represent 20-Year Average

Sources		Uses	
State payment	\$50 m	Debt service	\$133 m
City		Maintenance & Replacement	\$109 m
Capital budget	\$18 m	Administration	\$1 m
Local Sales Tax	\$121 m		
Meal & Beverage Tax	\$20 m		
Share of VLT Revenue **	\$8 m		
Interest on fund balance	\$28 m	Transfer to fund balance	\$1 m
TOTAL SOURCES	\$245 m	TOTAL USES	\$244 m

State Payment: As indicated above, adequate school facilities are part of the state’s constitutional responsibility to provide for a thorough and efficient system of free public schools. As such, it is appropriate for the state to make a commitment to bring city school buildings to an adequate condition, sufficient to allow students to succeed and meet state standards.

During the construction phase, a \$100 million state payment takes the place of the city’s normal share of state school construction funding. The state payment would need to come from current state revenues – not bond proceeds, since it would be used in part for debt repayment. In the repayment phase, the state payment to the Partnership organization declines to \$50 million – however, the city should resume receiving allocations from the regular state Public School Construction Program at that time.

City Payment: The city would also make a 30-year commitment to the financing of the construction program. This proposal would require an \$18 million payment from the city to the Partnership organization beginning in 2012. This funding would also need to come from current revenues, not bond proceeds, so that the partnership could use it for debt repayment.

Local Sales Tax: The largest revenue source for repayment would be a local-option sales tax equaling 1% of taxable sales in addition to the existing 6% state sales tax. State law would need to be changed to allow for an optional local sales tax in Baltimore City. The legislature could authorize this local option for all jurisdictions of the state. Other counties may wish to avail themselves of the opportunity to raise additional tax revenues for school facilities as well. The additional local sales tax could be subject to a referendum of voters in the jurisdiction.

Nationally, local option sales taxes are a common local revenue item for school construction. Jurisdictions will add a cent or half-cent to the sales tax and devote the revenue to a specified purpose, including school construction and renovation. The boost in the sales tax is often limited in time with the need for voters to re-authorize it for the specified purpose.

In 1985, the Georgia legislature approved the Special Purpose Local Option Sales Tax (SPLOST) to finance capital projects. In 1996, voters approved a constitutional amendment to allow local school boards to levy an Educational SPLOST, known as E-SPLOSTs, to fund school construction and renovation. Nearly every county and city in Georgia has taken advantage of the SPLOST to build and renovate schools.

Several counties in neighboring Florida have approved local sales taxes to fund school infrastructure. In 1998, voters in Bay County authorized a half-cent sales tax with a ten-year period. The half-cent tax funded more than \$100 million in infrastructure projects at 28 schools in the district. Orange County voters also approved a half-penny sales tax in 2002 to finance school construction.

Every county in Iowa has opted to employ the one percent School Infrastructure Local Option (SILO) sales tax. The proceeds from each county are pooled and distributed back to school districts by the state, except in the last two counties to adopt a SILO tax where 100% of proceeds are retained by the county. In FY 2006, SILO taxes generated more than \$211 million to fund school construction and renovation.

One cent per dollar of taxable sales in Baltimore City is conservatively estimated to generate \$67 million in 2012. This amount could be estimated to increase by 3% each year.

Meal and Beverage Tax. A meals and beverage tax is a consumption-based tax on meals and prepared foods and is used by many jurisdictions to raise revenue. A meals tax for Baltimore City would require enabling state legislation. Massachusetts has a commonwealth-wide meals tax of 5% and New Hampshire charges a statewide meals tax of 8%. Five counties in North Carolina, including Mecklenburg County in metropolitan Charlotte, have a 1% meals tax. Examples of local meals taxes in Virginia include 5.5% in Virginia Beach, 6% in Richmond, and 6.5% in Hampton, Norfolk, and Newport News. With about \$1.1 billion in sales of meals and prepared foods in Baltimore City in FY 2008, a one percent meals tax would raise about \$11 million a year. This amount could be estimated to increase by 3% to 5% on average.¹

From FY 2000 to FY 2008 city sales of meals and prepared foods grew at an average rate of 2.9%. The federal Consumer Expenditure Survey reports an average annual increase of 4.2% in average consumer spending of food away from home in Baltimore City from 2000 to 2007. For this financing model, the 2.9% growth rate in related sales was used to grow meals tax revenue over time, although the consumer spending data suggest the rate of revenue growth may be greater.

The federal consumer spending data report average spending on food away from home in Baltimore City was \$2,836 in the 2006-2007 survey. Spending on food away from home increased 39% in 2006-2007 and 22% in the 2005-2006 survey. Due to the economic downturn, spending growth will likely slow in upcoming surveys.

¹ See FY 2008 Sales Tax Report, page 4, data for “Independent Groceries,” “Restaurants, Lunchrooms, Delicatessens,” “Supermarkets,” “Hotels, Motels Selling Food,” “Package Liquors and Taverns,” and “Restaurants and Night Clubs.” This revenue projection assumes that 67% of sales were food in the categories of “Hotels, Motels Selling Food” and “Restaurants and Night Clubs;” and that 25% of sales in “Package Liquors and Taverns” were food.

Video Lottery Revenues. State law provides for a share of the revenues from video lottery terminals (slot machines) to be distributed to the local governments where slot machine facilities are located. Baltimore City's share was initially estimated at \$19 million annually. Due to delays in awarding a license to an operator, the estimate is more likely to be approximately \$15 million. By law, the slot revenue can be used for school construction or property tax reduction. Our recommendation is to fully dedicate the proceeds to school buildings through fiscal year 2022. Then half will continue to be used for school buildings and half for property tax reduction or other purposes through 2028. At that point, only 25% of slot machine revenue will be needed for the building program, and 75% can be allocated for property tax reduction and other purposes.

Interest on Fund Balances. We estimate that interest earnings on unspent balances will provide an average of \$28 million per year for the first ten years of the program.

Other Revenue Options

There are a number of other possible revenue sources that are not included in this financing plan. The selection of revenues to be dedicated for the construction program will relate to a wide variety of factors. City and state leaders will need to settle on an appropriate package, and it may well differ from the sources shown for illustration purposes in this report. Many of these options were considered by the Mayor's "Blue Ribbon Committee on Taxes and Fees" in 2007, while others were incorporated in Baltimore City's proposed budget plan in 2010.

- Increasing the threshold on homestead property tax exemption
- Regional sales tax
- Impose solid waste fees
- Increase beverage-container tax
- City hotel tax
- "Commuter" payroll tax
- Plastic bag tax

Additional Financing Opportunities

Baltimore City Public Schools and the Partnership organization should identify and employ other innovative opportunities to leverage funding and resources available for financing the school construction plan.

Public-Private Partnerships

There are a number of models emerging for public-private partnerships to finance or subsidize school facilities. The Baltimore City Public Schools and the Partnership may be able to negotiate arrangements with private developers to build or renovate schools. These could include:

- Lease-leaseback arrangements,

- Opportunities to transfer city-owned properties to a developer in exchange for construction or renovation of school facilities, or
- Assistance with school building improvements in association with commercial or residential development, as part of a community benefits agreements.

Such initiatives could reduce the partnership's financing costs or allow for completion of the construction program to be expedited.

Build America Bonds

Congress has authorized state and local governments to issue "Build America Bonds" in which investors receive interest subsidies in the form of federal tax credits. Future authorizations of Build America Bonds could be used instead of revenue bonds to fund a portion of the partnership school construction program.

Contingencies

The financing plan is based on a number of estimates and assumptions. Variations of these factors will affect the amount of construction that can be financed, the amount of revenue needed and/or the time frame for completion of the project.

- Construction costs
- Interest rates
- Revenue Estimates
- New needs and opportunities

Conclusion

The needs of Baltimore City's school students for adequate learning environments are critical and urgent. Meeting those needs is part of the state's Constitutional requirement to provide a thorough and efficient system of education. Further, investing in a plan to rebuild Baltimore's school infrastructure will bring invaluable returns to the city.

This report shows one way to fully meet this need in the space of a decade. It requires some extraordinary action – a sustained financial and management commitment by the state, the city and the school system. But it's possible, and it will have both immediate and long-term benefits that far outweigh its costs.