

STATE SHOULD REPEAL CAPITAL GAINS TAX REDUCTIONS AND ALTERNATIVE FLAT TAX

Rhode Island has a long history of using its collective resources to enhance the quality of life for all its residents. From colleges, universities and schools to parks, beaches, and libraries to health care for seniors, people with disabilities and working families, we have invested in the kinds of public systems that make communities thrive.

In November 2007 state fiscal advisors projected a \$400-\$450 million deficit for Fiscal Year 2009 and continuing deficits in future years. Rhode Islanders deserve a balanced approach to closing the budget gap in 2009 and getting our fiscal house in order for the long term. Slashing funding for our critical public services while not reversing recent tax cuts will weaken our most basic protections and undermine the quality of life for us all.

Restoring the state's tax on long-term capital gains and repealing the alternative flat tax are two necessary steps to restoring much needed state revenues. Reversing these two tax cuts is also required to address Rhode Island's long-term structural deficit to avoid the growing loss of revenue as the alternative flat tax is fully phased in.

- The capital gains tax cut and the alternative flat tax are unaffordable. In fiscal year 2009 these two tax cuts alone will cost the state more than \$62 million dollars.

- There is no evidence capital gains tax cuts are needed to be competitive with neighboring states or that the alternative flat tax will contribute to economic development.

Capital Gains Tax Reductions and Alternative Flat Tax are Unaffordable

Rhode Island stands to lose more than \$62 million in FY2009 from the recent reduction in the capital gains tax and the enactment of the alternative flat tax.

In 2002, Rhode Island enacted legislation that would phase-out and eventually eliminate taxes on capital gains from the sale of assets held for more than five years (RIGL 44-30-2.7). Capital gains are profits from selling an asset such as a stock, bond or business. The first step in this phase-out was a reduction in the tax rate on long-term capital gains from 5% to 1.7% which occurred in tax year 2007. The tax was scheduled to be eliminated entirely beginning in tax year 2008 but in 2007 the General Assembly voted to freeze the rate at 1.7%.

The reduced rate (1.7%) will cost the state \$19.5 million in lost revenue in FY 2008, when it will be in effect for only half the fiscal year. In Fiscal Year 2009, when the reduced rate is in effect for the full year, it will cost the state \$39 million.¹

In 2006, the Rhode Island General Assembly passed the alternative flat tax which allows taxpayers to choose between paying the personal income tax rate and applying allowable deductions and credits or paying a flat tax rate which would apply to all income, without credits or deductions. The flat tax rate started at 8.0% in 2006 and will be reduced to 7.0% in 2008; it is scheduled to fall every year until it reaches 5.5% in 2012.

The Division of Taxation and legislative fiscal staff estimate that the flat tax will cost the state \$23.4 million in FY 2009 and \$68 million by FY 2012 when it is fully phased in.

	REVENUE LOST FY09
CAPITAL GAINS TAX CUT	\$39 MILLION
ALTERNATIVE FLAT TAX	\$23.4 MILLION
TOTAL	\$62.4 MILLION

Source: House Fiscal staff estimates

- The majority of these tax cuts help a minority of wealthy Rhode Islanders and out of state residents. Most of the "savings" realized by taxpayers through each tax cut goes to only 2-3% of the highest-income households in the state.

Table 1. Eighty percent of capital gains income received by 2.5% of high-income Rhode Islanders

INCOME CATEGORY	\$0 to \$50,000	\$50,001 to \$75,000	\$75,001 to \$100,000	\$100,001 to \$200,000	Over \$200,000
% OF ALL TAX RETURNS FILED	66.7%	14.0%	8.3%	8.6%	2.5%
NUMBER OF TAXPAYERS REPORTING CAPITAL GAINS INCOME	14,055	8,787	7,743	13,003	7,650
% OF NET CAPITAL GAINS REPORTED	2.0%	2.3%	2.9%	12.1%	80.6%
AVERAGE AGI	\$19,688	\$61,407	\$86,246	\$130,989	\$520,585
AVERAGE NET LONG-TERM CAPITAL GAIN	\$2,077	\$3,267	\$4,799	\$4,799	\$193,113
AVG. CAPITAL GAINS TAX SAVINGS AT 1.67% RATE FOR FILERS REPORTING CAPITAL GAINS	\$70	\$109	\$162	\$408	\$4,974

Source: Poverty Institute analysis of Rhode Island Division of Taxation data.

Majority of Tax Cuts Help a Minority of Wealthy RI Taxpayers and Out of State Residents

Both the capital gains tax cut and the alternative flat tax primarily benefit Rhode Islanders earning more than \$200,000 annually.

According to the Rhode Island Statistics of Income, 80.6 percent of all net income from capital gains in Rhode Island was reported by taxpayers with an adjusted gross income (AGI) of \$200,000 or more for 2005. This group represented only 2.5 percent of Rhode Island tax filers. The average AGI reported by these taxpayers was \$520,585 – nearly 10 times the average AGI on all other Rhode Island returns of \$53,167. The average capital gain reported by these high-income taxpayers was \$193,113. (Table 1)

In FY2009, the flat tax is expected to benefit only 1,884 Rhode Island taxpayers and 2,500 non-residents who will receive an average tax cut of \$5,337.

In 2012, when it is fully phased in, most of the tax cut “savings” will go to those who earn at least \$336,550, about 1% of RI taxpayers. As the alternative tax rate falls to 5.5%, more high income filers will choose to forego credits and deductions and opt to pay the flat tax instead. By 2012, when the tax cut has been fully phased in, 7,416 residents are expected to choose the flat tax option. An additional 5,703 non-residents who work in Rhode Island but live in another state are expected to choose the flat tax option. The average tax savings for this group will be approximately \$5,156. (Table 2)

The majority of Rhode Island taxpayers will not benefit from the flat tax.

Table 2. FLAT TAX: Tens of millions of dollars foregone, small number of RI residents and non-residents benefit

FISCAL YEAR	FLAT TAX RATE	# OF RESIDENTS EXERCISING OPTION	# OF NON-RESIDENTS EXERCISING OPTION	TOTAL COST TO STATE (MILLIONS)	AVERAGE TAX CUT
FY2009	7.0	1,884	2,500	\$23.4	\$5,337
FY2010	6.5	3,054	3,316	\$37.3	\$5,863
FY2011	6.0	4,709	4,292	\$53.5	\$5,942
FY2012	5.5	7,416	5,703	\$68.7	\$5,156

Source: House and Senate Fiscal Advisory Staff, 2006 and 2007 estimates

Arguments for Tax Cuts Don't Hold Up

When the General Assembly voted to eliminate capital gains taxes, they were persuaded in part by similar legislation enacted in Massachusetts and the belief that the Ocean State needed to remain competitive with its neighbor. Massachusetts, however, has since repealed its elimination of taxes on long-term gains because of the strain it put on state finances. Currently, Massachusetts taxes long-term capital gains as ordinary income at 5.3%. Rhode Island's original rate of 5% would allow the Ocean State to remain competitive with its neighbor.

Table 3 demonstrates the revenue that Rhode Island could recapture in FY2009 if it were to increase the capital gains tax rate at various increments, up to its original 5%.

Proponents of the flat tax argued that cutting taxes on high-earners would encourage the wealthy to live and invest in Rhode Island, bringing jobs to the state. Yet economic studies find little relationship between job growth and tax cuts.² Proponents also contend that the rate of growth of upper-income residents has not been as strong as neighboring states. Yet, the number of Rhode Island taxpayers reporting incomes of \$200,000 and above more than doubled from 1997 – 2005, while the incomes earned by the top 1% rose by 12%. These rates of growth are considerably higher than in Massachusetts or Connecticut.³

Table 3. Incremental increases to capital gains rate would recapture revenue

If tax rate were increased to:	The state would raise this amount in FY09:
2.0%	\$1.9 MILLION
2.5%	\$4.75 MILLION
3.0%	\$7.6 MILLION
3.5%	\$10.45 MILLION
4.0%	\$13.3 MILLION
4.5%	\$16.15 MILLION
5.0%	\$19.0 MILLION

Source: Poverty Institute calculations based on House Fiscal estimates.

¹ Poverty Institute calculations based on IRS Statistics of Income data for tax year 2005 and fiscal estimates by House Fiscal Advisory Staff, 2007.

² WR Reed and CL Rogers, *Tax Cuts and Employment in New Jersey: Lessons from a Regional Analysis*, Public Finance Review, May 2004; Institute for Taxation and Economic Policy, *High Income Tax States Have Strong Economies*, December 1999; Howard Chernick, *Tax Progressivity and Economic Performance*, Economic Development Quarterly, August 1997; Sally Wallace, *The Effect of State Personal Income Tax Differentials on Interstate Competition*, State Tax Notes, December, 1991; Robert Lynch, *Rethinking Growth Strategies: How State and Local Taxes and Services Effect Economic Development*, Economic Policy Institute, March 2004.

³ See *Income Gains and Charitable Giving Among Wealthy Rhode Island Taxpayers Exceed Neighbors*, Poverty Institute, September 2007.