

Destination: Tax Reform

Presentation to the 2009 *Budget Rhode Map* Conference

Jeff McLynch

Institute on Taxation & Economic Policy

www.itepnet.org

jmclynch@itepnet.org

202.299.1066 x29

Destination: Tax Reform

Overview

- ❖ Introduction

- ❖ Assessing Rhode Island's Tax System

Inadequate

Inequitable

Inefficient

- ❖ Improving Rhode Island's Tax System

Repeal the alternative flat tax

Repeal preferential rates for capital gains

Institute combined reporting

Expand sales tax base and enhance the EITC

- ❖ Putting Improvements in Context

- ❖ Anticipating the Workgroup's Recommendations

Destination: Tax Reform

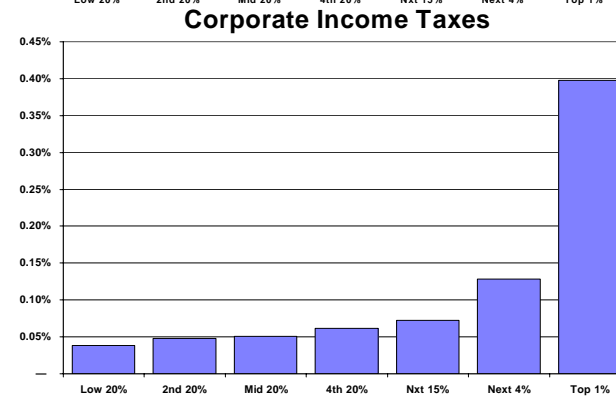
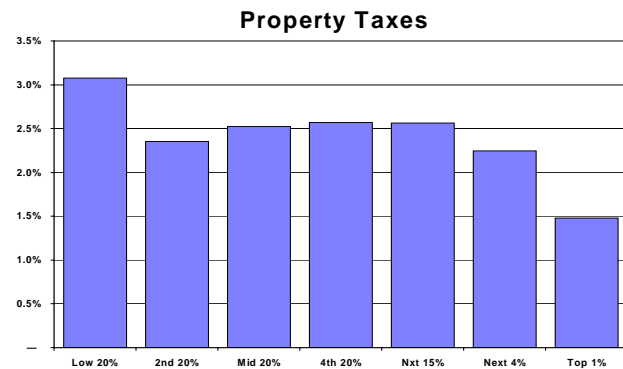
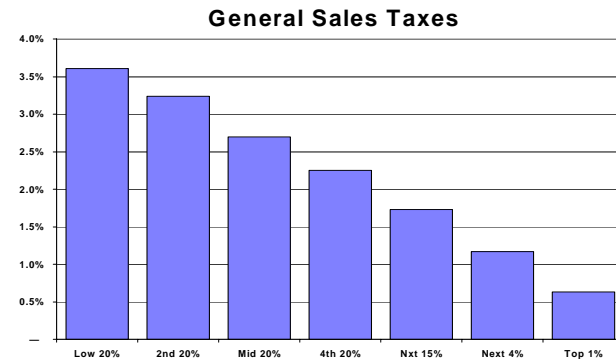
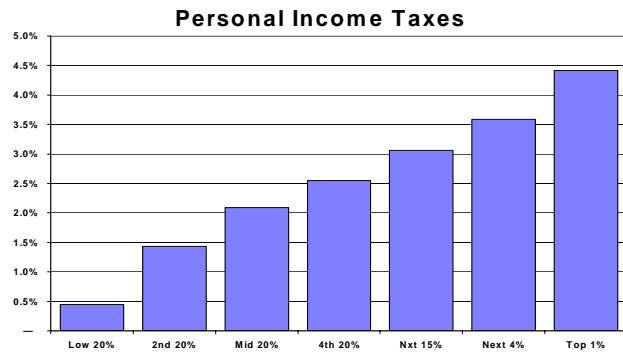
Introduction – Hello, My Name is ITEP

- ❖ **Founded in 1980**
- ❖ **Based in Washington, DC**
- ❖ **Research focuses primarily on state tax issues, with an emphasis on tax fairness and adequacy**
- ❖ **In the past five years, conducted studies of state tax systems in LA, MD, MS, IN, AR, IL, IA, MN, and NY**
- ❖ **Conducted hundreds of smaller-scale tax analyses in over 40 states**
- ❖ **Data presented today will be part of forthcoming 50 state *Who Pays?* Publication**
- ❖ **In conjunction with Citizens for Tax Justice, publishes weekly newsletter, the *Tax Justice Digest*, that reviews the latest developments in federal and state tax policy**

Destination: Tax Reform

Introduction – Key Concepts in Tax Incidence

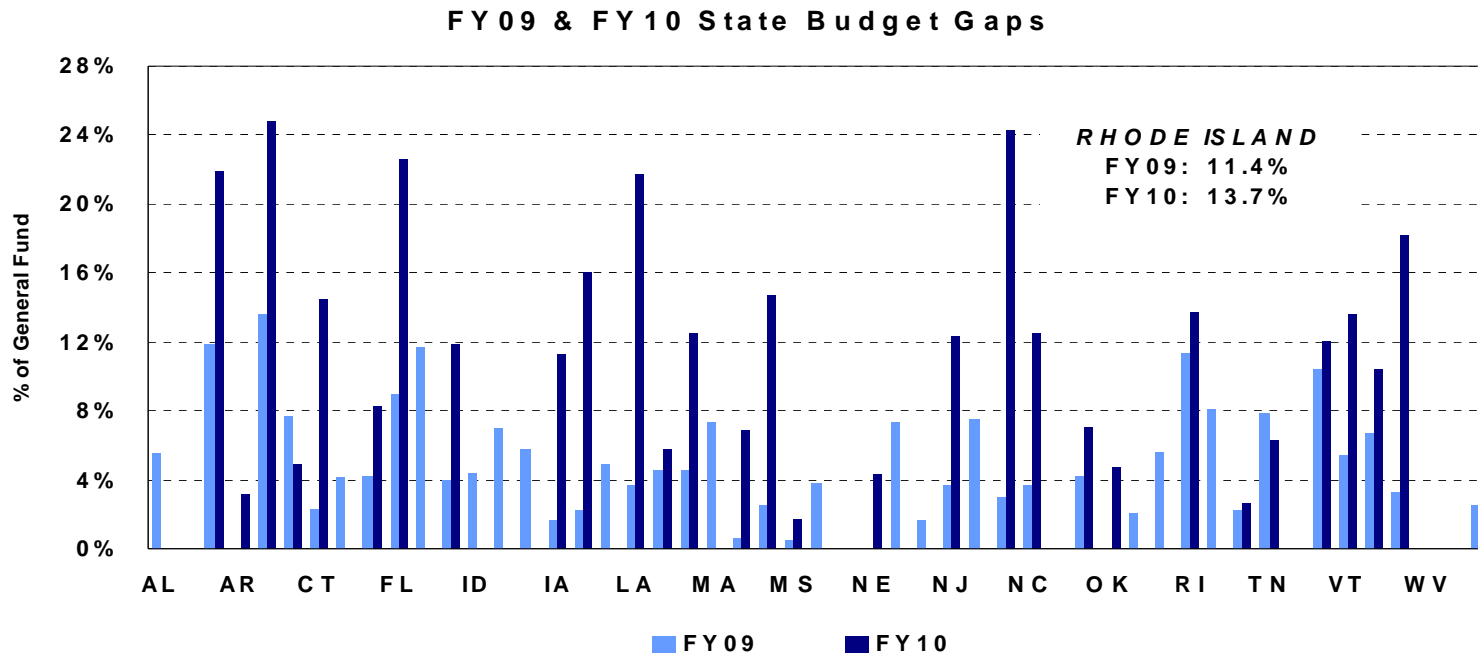
Taxes may be progressive, proportional, or regressive. For instance:



Destination: Tax Reform

Assessing Rhode Island's Tax System

Rhode Island's tax system is *inadequate*.

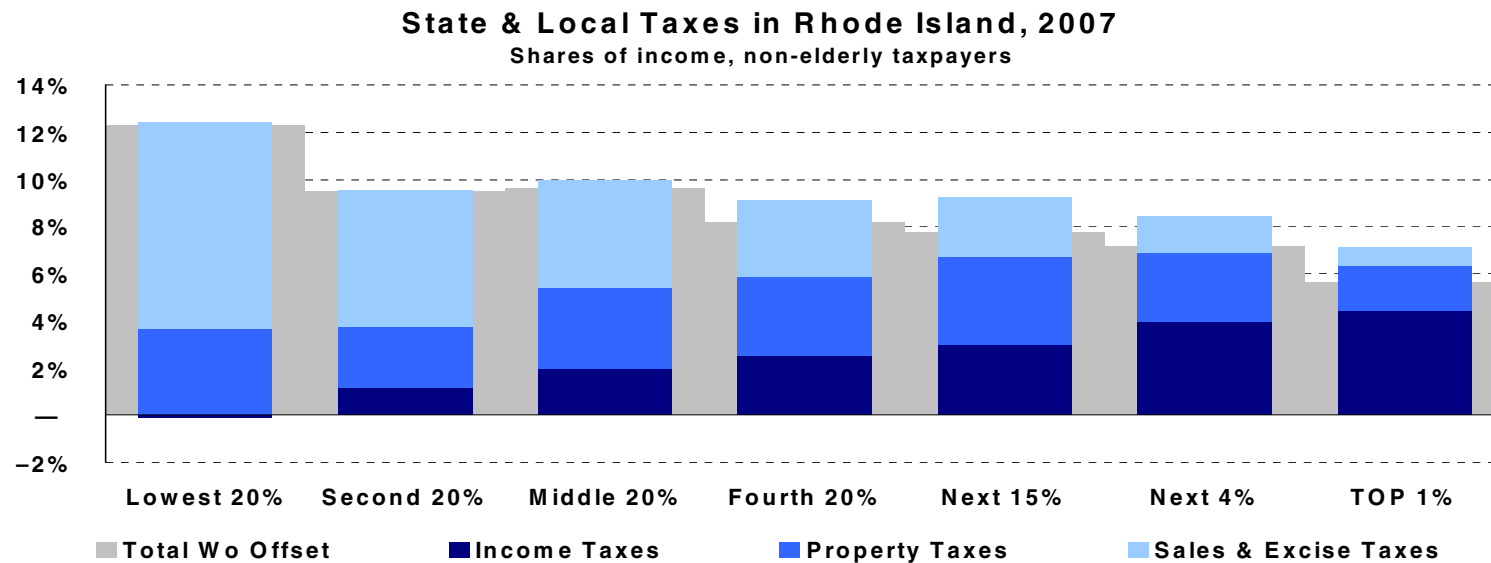


Source: Center on Budget and Policy Priorities

Destination: Tax Reform

Assessing Rhode Island's Tax System

Rhode Island's tax system is *inequitable*, as it requires low- and moderate-income families to pay larger shares of their incomes in taxes than upper-income families



Source: ITEP Microsimulation Model

Destination: Tax Reform

Assessing Rhode Island's Tax System

- ❖ The poorest fifth of Rhode Islanders – individuals and families with incomes of less than \$17,000 in 2007 – pay **12.3** percent of their incomes in taxes on average.
- ❖ Middle-income residents – whose incomes range from \$31,000 to \$51,000 – pay **9.6** percent on average (after accounting for the impact of the federal offset).
- ❖ The wealthiest 1 percent of Rhode Islanders – taxpayers whose average income amounted to **\$1.2 million** in 2007 – pay **5.7** percent (again, post-offset).
- ❖ In short, relative to their incomes, the most affluent Rhode Island residents pay **less than half as much in taxes** as poor and middle-income residents.

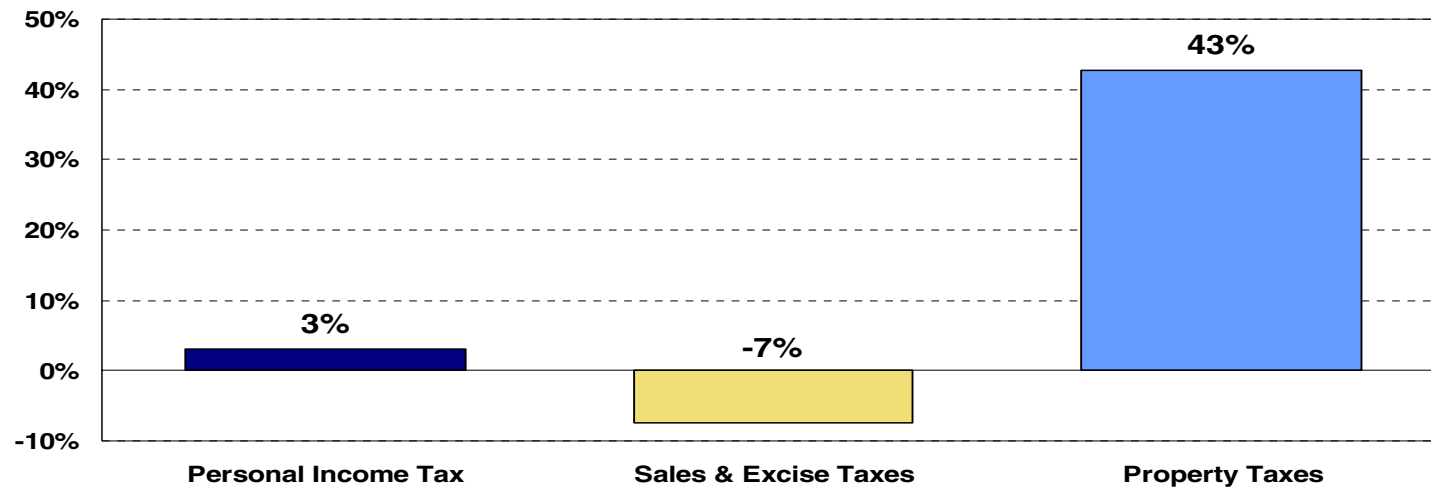
Destination: Tax Reform

Assessing Rhode Island's Tax System

Rhode Island's tax system is *inequitable*, due in part to the mix of state and local taxes levied

Select RI Taxes Relative to US Average

FY 2006



Source: U.S. Census Bureau; Bureau of Economic Analysis

Destination: Tax Reform

Assessing Rhode Island's Tax System

Rhode Island's tax system is *inequitable*, due in part to the mix of state and local taxes levied

Rhode Island State & Local Taxes as a Share of Personal Income, 2006

	Personal Income Tax		Sales & Gross Receipts Taxes		Property Taxes		Corporate Income Tax	
		Rank		Rank		Rank		Rank
Maine	3.3%	12	4.0%	21	5.3%	3	0.5%	24
New Hampshire	0.2%	42	1.4%	48	5.5%	1	1.1%	4
Vermont	2.6%	29	3.9%	23	5.5%	2	0.4%	31
Massachusetts	3.6%	6	2.1%	45	3.7%	17	0.6%	9
Rhode Island	2.6%	24	3.6%	32	4.8%	6	0.4%	26
Connecticut	3.4%	10	2.9%	41	4.4%	8	0.4%	35
New York	4.8%	1	3.9%	22	4.5%	7	1.1%	2
All States	2.5%		3.9%		3.4%		0.5%	
Addendum: Rhode Island Compared to National Average								
	+3%		-7%		+43%		-13%	

Source: Bureau of Economic Analysis; Bureau of the Census

Destination: Tax Reform

Assessing Rhode Island's Tax System

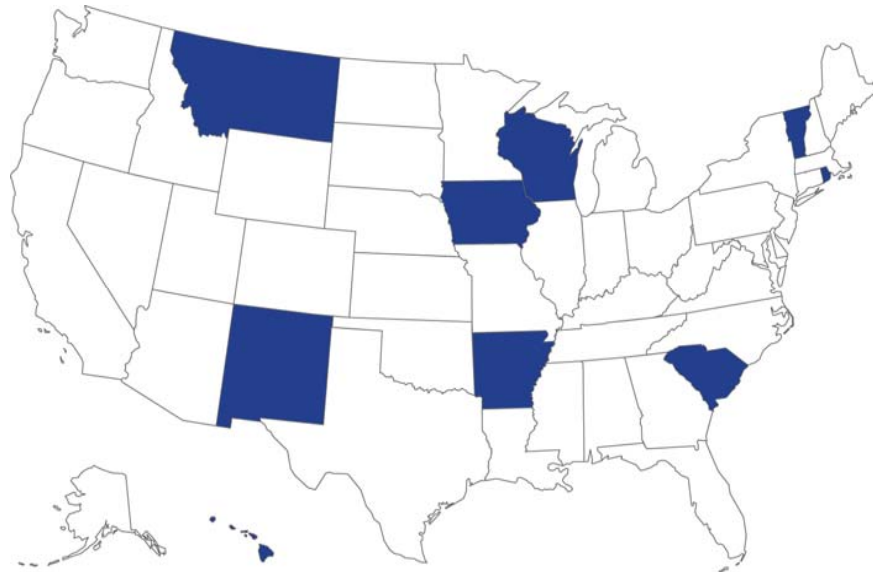
Rhode Island's personal income tax is *inefficient*, as it favors certain forms of income over others

Capital Gains Tax Preferences

"...a cut in the tax rate on capital gains is unlikely to have much effect on saving and investment..."

"...tax preferences are more likely to depress economic productivity than to improve it..."

-- Leonard Berman, *The Labyrinth of Capital Gains Tax Policy*

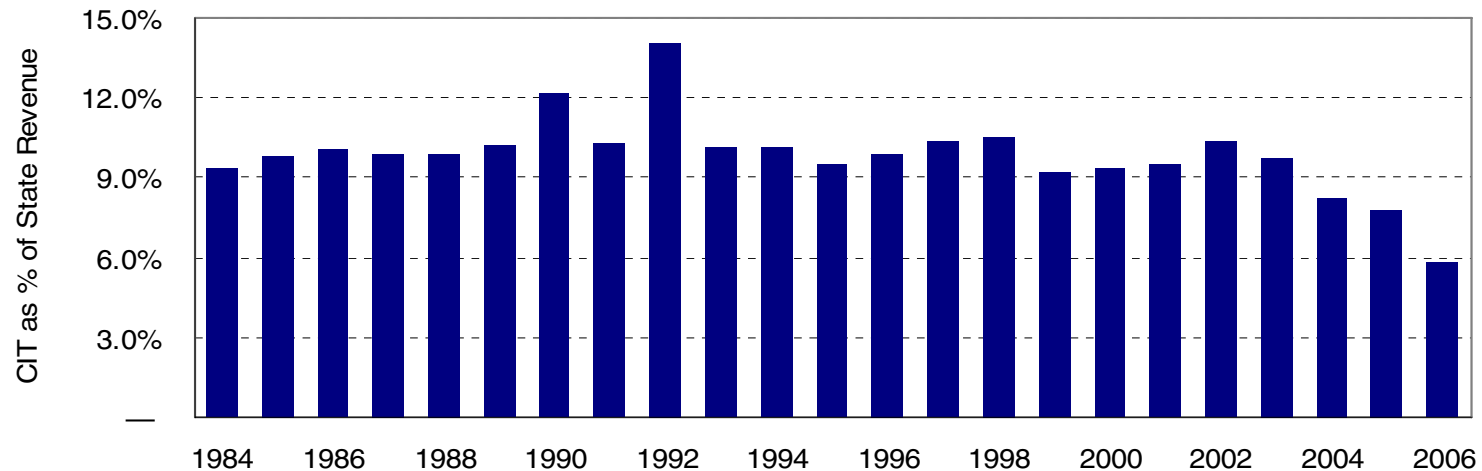


Destination: Tax Reform

Assessing Rhode Island's Tax System

Rhode Island's corporate income tax is *inefficient*, as it is vulnerable to a wide variety of schemes designed to shift income out of state and to reduce taxes paid

RI Corporate Income Tax Plays a Much Smaller Role in State Finances



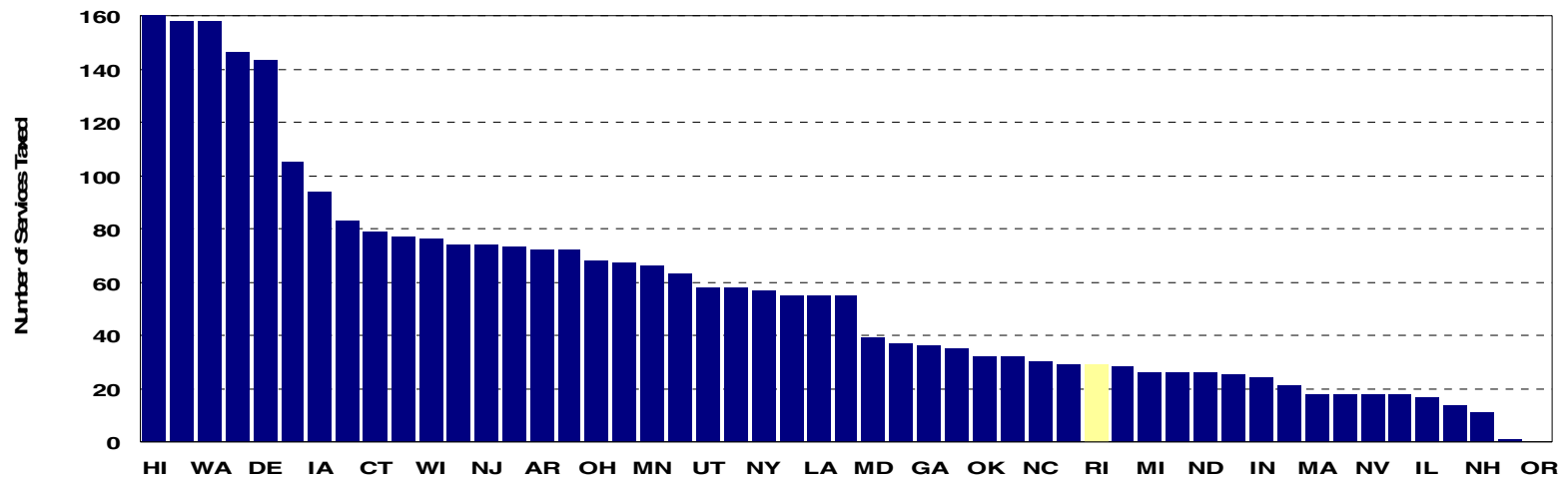
Source: U.S. Census Bureau

Destination: Tax Reform

Assessing Rhode Island's Tax System

Rhode Island's sales tax is *inefficient*, as it fails to include as much of the state's economic activity in its base as possible

Sales Taxation of Services, 2007



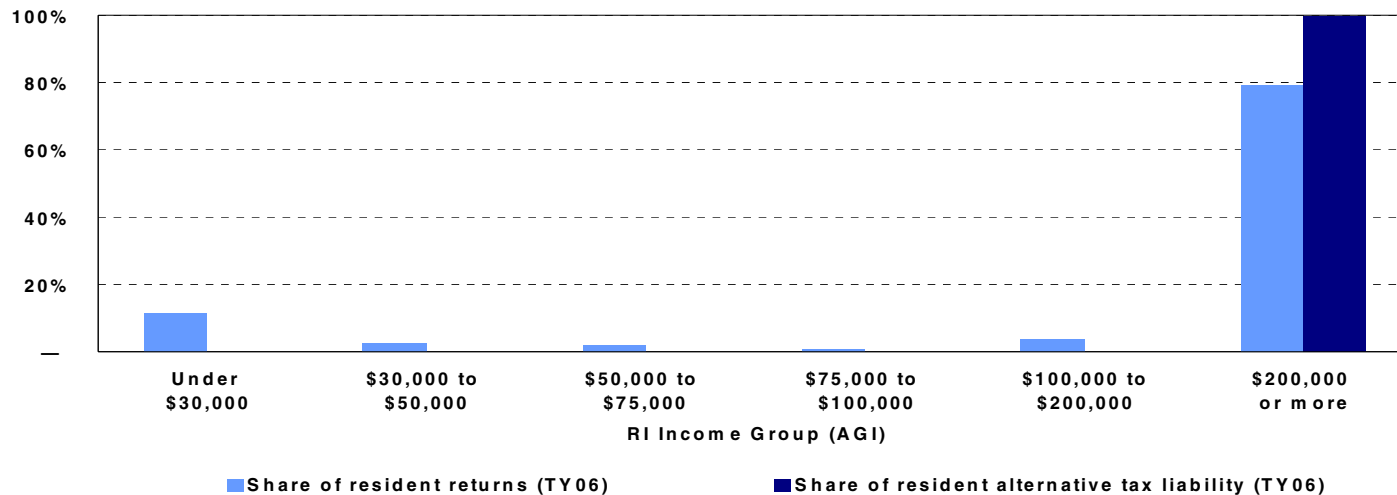
As of 2007, services constituted 60 percent of consumption nationwide; yet, according to the FTA, Rhode Island taxed just 29 out of a possible 168 services

Destination: Tax Reform

Improving Rhode Island's Tax System

Repealing the alternative flat tax would forestall the loss of as much as \$76 million per year in revenue, would improve tax fairness, and would simplify the tax code

Alternative Flat Tax Returns & Liability
Concentrated at the Very Top



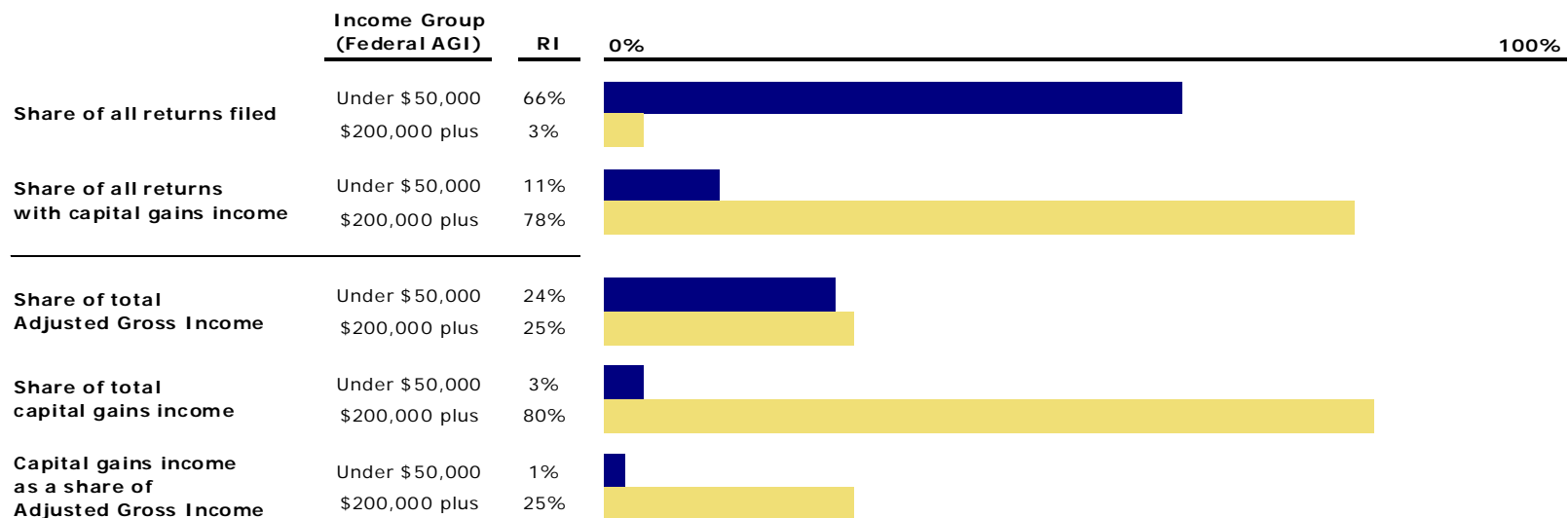
Source: RI Division of Taxation, 2006 Statistics of Income

Destination: Tax Reform

Improving Rhode Island's Tax System

Taxing capital gains at the same rate as earned income could yield as much as \$43 million annually, would improve tax fairness, and would simplify the tax code

Capital Gains Income Among Federal Taxpayers, 2006

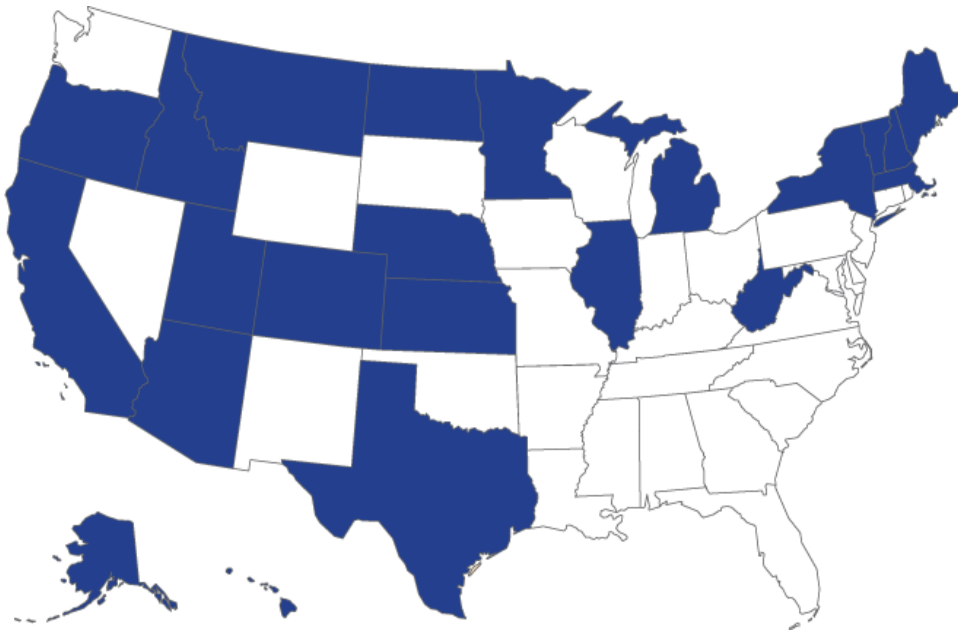


Source: IRS, 2006 Statistics of Income (SOI)

Destination: Tax Reform

Improving Rhode Island's Tax System

Instituting combined reporting would nullify a wide range of tax planning techniques, both ensuring that large & profitable businesses pay their fair share and leveling the playing field between multistate and locally-owned and –operated businesses



Twenty-two of the forty-five states that levy a corporate income tax now use combined reporting

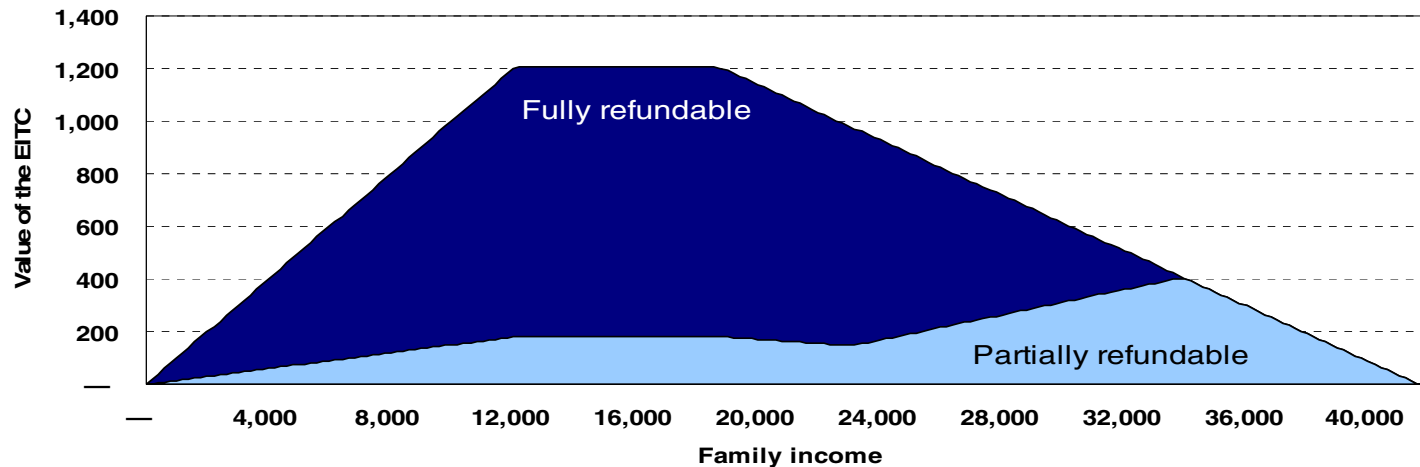
Three northeastern states – VT, MA, NY – have adopted combined reporting in the last five years

Destination: Tax Reform

Improving Rhode Island's Tax System

Expanding Rhode Island's sales tax base would generate significant new revenue (perhaps as much as \$300 million) but would fall principally on low- and moderate-income taxpayers; thus, such a change should be paired with enhancements to the state Earned Income Tax Credit (EITC)

Two Versions of the Rhode Island EITC
Partially v. Fully Refundable - Married Couple with 2 Children



Destination: Tax Reform

Putting Improvements in Context

The Short Run – Responding to the Recession

“...economic theory and evidence gives a clear and unambiguous answer: it is economically preferable to raise taxes on those with high incomes than to cut state expenditures.”

“...in a recession, you want to raise (or not decrease) the level of total spending – by households, businesses, and government...”

...raising taxes on high income households ... will reduce spending, but by less than the amount of the tax increase since those with plenty of income typically spend only a fraction of their income ...”

– Joseph Stiglitz, 2001 Nobel Prize winner, letter to the NY Governor, Speaker of the House, and Senate Majority Leader, March 27, 2008

Destination: Tax Reform

Putting Improvements in Context

The Long Run – Laying the Foundation for Economic Growth

“Numerous studies have empirically proven that education has a large impact on a region's subsequent economic growth rate and on individual earnings.

Education investments — beginning with early childhood education, elementary/secondary through higher education and workforce training — increase the quality of the current and future workforce and are influential in attracting businesses, valuable professionals, and skilled workers to the state.”



Destination: Tax Reform

Putting Improvements in Context

The Long Run – Laying the Foundation for Economic Growth

“Economic studies show that infrastructure is a complement to private capital.

It creates the conditions for growth by reducing costs of production and raising the returns to other capital and labor.

Businesses understand this; one business survey puts transportation at the top of the list of possible impediments to business and economic performance.”

Global Insight, Economic Impacts of Eliminating the Massachusetts State Income Tax, October 2008

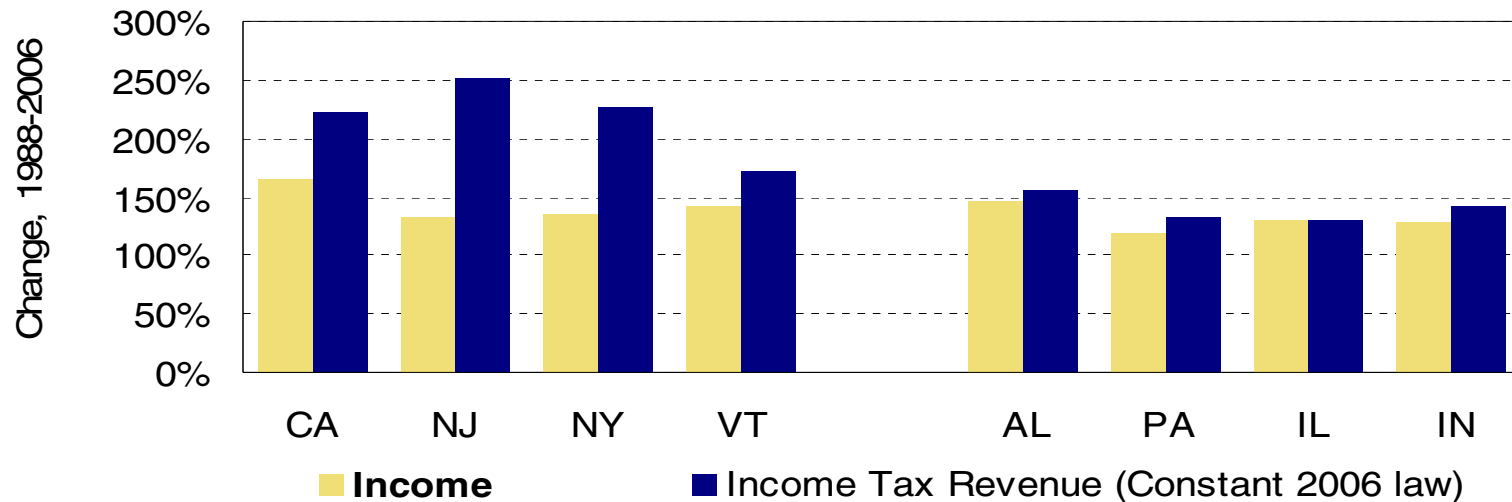


Destination: Tax Reform

Putting Improvements in Context

The Long Run – Creating a Sustainable Tax System

Progressive Income Taxes Are More Sustainable



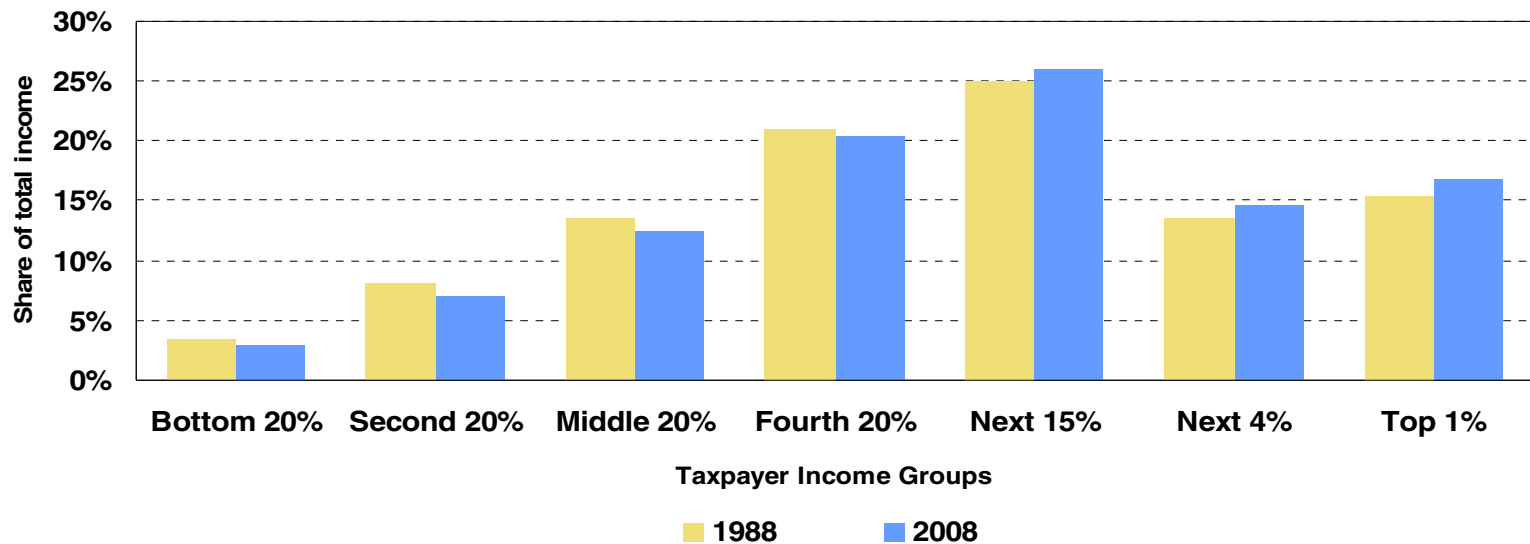
Source: ITEP Microsimulation Model

Destination: Tax Reform

Putting Improvements in Context

The Long Run – Creating a Sustainable Tax System

Distribution of Income in RI, 1988 - 2008



Source: ITEP Microsimulation Model

Destination: Tax Reform

Anticipating the Workgroup's Recommendations

Possible areas of agreement?

- ❖ **Eliminate the alternative flat tax**
- ❖ **Repeal capital gains tax preferences**
- ❖ **Broaden the sales tax base**
- ❖ **Make the EITC fully refundable**

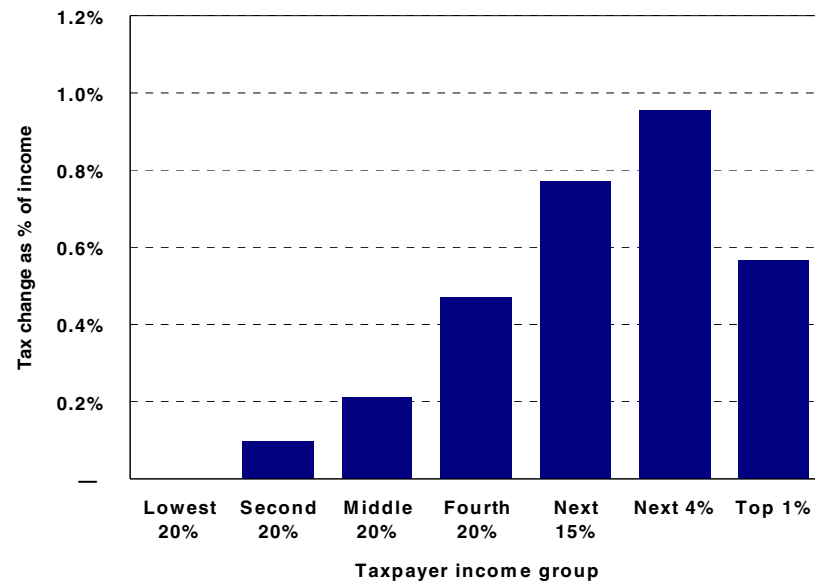
Destination: Tax Reform

Anticipating the Workgroup's Recommendations

Repealing itemized deductions – another area of agreement?

- ❖ Would generate substantial revenue (~\$200M)
- ❖ Would affect only about one-third of RI taxpayers
- ❖ Would be highly progressive
- ❖ Would be partially offset by lower federal income taxes

Impact of repealing RI itemized deductions



Source: ITEP Microsimulation Model

Destination: Tax Reform

Anticipating the Workgroup's Recommendations

Likely areas of disagreement

The Workgroup's recommendations may:

- ❖ Fail to generate additional revenue either to address the budget deficit or to enable changes in the property tax
- ❖ 'Flatten' the income tax dramatically
- ❖ Eliminate or alter significantly Rhode Island's estate tax
- ❖ Reduce corporate income tax rates substantially without minimizing corporate tax avoidance

If this is the case, areas of agreement may not mean much.

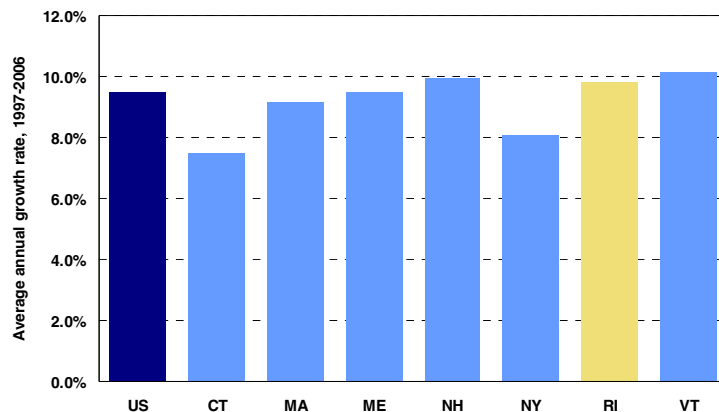
Destination: Tax Reform

Anticipating the Workgroup's Recommendations

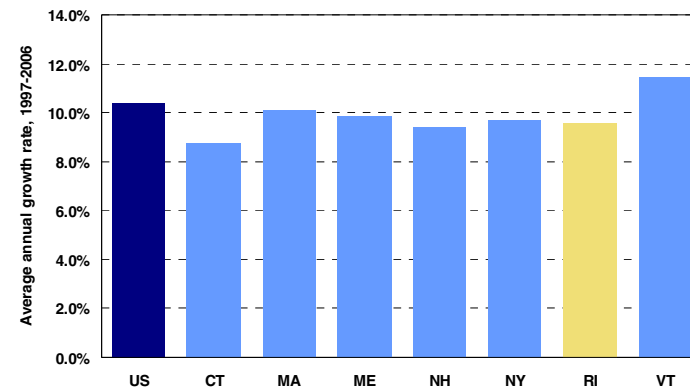
CLAIM: “A flatter income tax is necessary to keep (high-income) people from leaving the state”

FACT: The number of high-income taxpayers in RI – and the amount of income they earn – has grown over the last decade and done so in line with regional and national trends

Changes in number of high-income taxpayers in RI mirror the rest of the region



Changes in amount of income held by high-income taxpayers in RI mirror the rest of the region



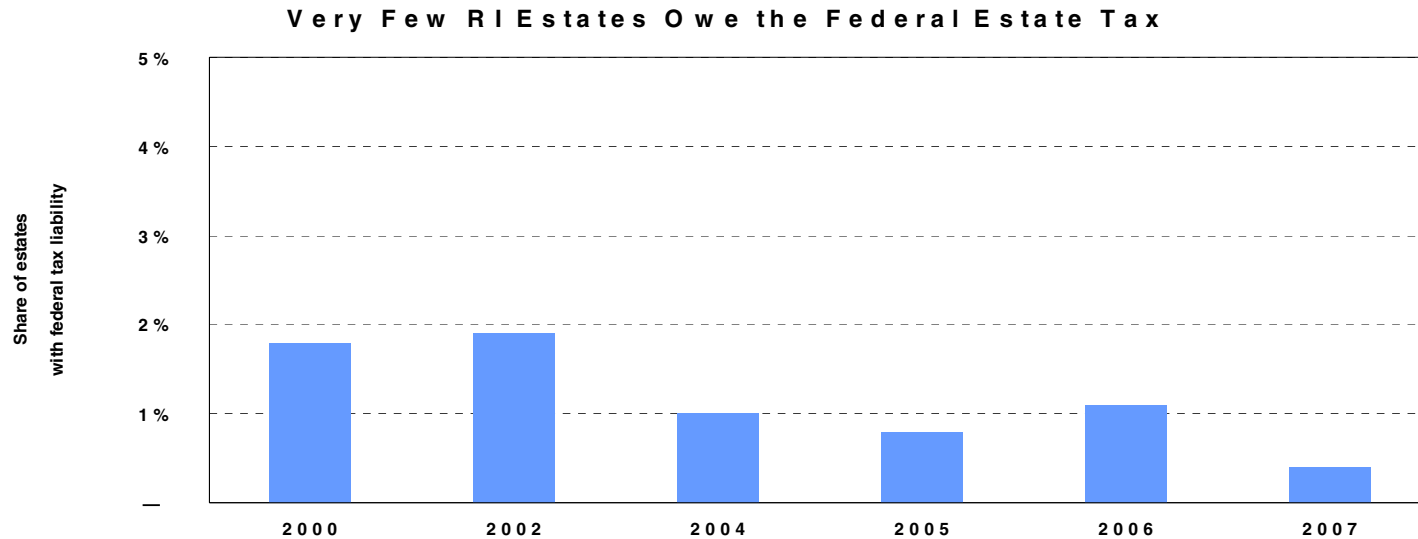
Source: IRS, 2006 Statistics of Income

Destination: Tax Reform

Anticipating the Workgroup's Recommendations

CLAIM: “Eliminating the estate tax will bring people back to RI”

FACT: Federally, less than 2% of RI estates incur an estate tax liability



Source: IRS, 2006 Statistics of Income

Destination: Tax Reform

Anticipating the Workgroup's Recommendations

One Final Area of Disagreement

Defining "Irresponsible"

"We have been told that the new Obama administration will move quickly on an economic stimulus package that could mean upwards of \$125 million in immediate relief to Rhode Island ... Should we receive Federal stimulus funds, we must not look backwards and simply use all of this money to avoid the tough decisions ...

We must plan on *using most of these funds to lower taxes* for individuals and businesses, create jobs and stimulate growth.

To do otherwise *would be irresponsible.*"

-- Governor Donald L. Carcieri, Address to the RI Public, January 7, 2009

Destination: Tax Reform

Review

- ❖ **At present, RI's tax system is inadequate, inequitable, and inefficient.**
- ❖ **Improvements can be made to address each of these shortcomings. Repealing income tax preferences, adopting combined reporting, and expanding the sales tax base would all be steps in the right direction.**
- ❖ **These improvements are both appropriate – given the short run context – and necessary – given long-term considerations.**
- ❖ **The Governor's Workgroup may take some of these steps, but those advances will become a retreat if it seeks to flatten the income tax rate structure, to cut corporate income tax rates, and to repeal the estate tax.**