

Proposed Restructuring of Rhode Island's Personal Income Tax (Article 38) is Expensive and Ineffective

The Governor's Fiscal Year 2010 Budget includes a number of proposed changes to the state's personal income tax that were recommended by his Tax Policy Strategy Workgroup. The proposed changes to the personal income tax will cause the state to lose significant amounts of revenue, is unlikely to be a cost effective strategy for growing jobs, and would present significant fiscal challenges as the changes are scheduled to take effect in 2011 - the same year federal stimulus funds are set to expire. The combined loss of federal funds and income tax revenue could cause a serious detour off Rhode Island's road to recovery.

Among several other changes, Article 38 proposes to:

- Flatten the income tax rates by reducing the number of brackets to four with a top marginal tax rate of 5.5 percent
- Eliminate all itemized deductions in exchange for a modestly increased standard deduction and personal and dependent exemptions
- Eliminate all personal income tax credits except for four (refundable earned income, property tax relief, lead paint abatement, and income taxes paid to other states) but allow accumulated tax credits (such as historic preservation credits) to be used until they are exhausted
- Tax capital gains as ordinary income regardless of how long an asset is held

EXPENSIVE

Proposal costs fifty percent (50%) more than flat tax. A recent evaluation by the Office of Revenue Analysis concludes that the Workgroup's personal income tax proposal endorsed by the Governor leads to an additional annual state revenue loss of \$40 million, representing a 4.5 percent reduction in income tax receipts.¹ This is over and above the loss of personal income tax revenue resulting from the implementation of the flat-tax option, which is estimated to be more than \$70 million annually.² In other words, the proposal increases the annual revenue loss already resulting from the flat tax on the order of an additional fifty percent, for a total of more than \$110 million annually.³

Uncertain capital gains income could underestimate revenue loss. There is a substantial risk that the revenue loss resulting from this proposal could be even larger and therefore even more damaging to the state's ability to fund critical services if capital gains income of Rhode Island taxpayers declines in line with current national forecasts. In his minority report, Workgroup member Michael Mazerov cites a January 2009 report by the Rockefeller Institute of the State University of New York at Albany that showed that 2006 and 2007 were high-water mark years for capital gains receipts. The report noted that such receipts are expected to decline by as much as 30-50 percent in 2008 and another 20-40 percent in tax year 2009.⁴

The Workgroup's proposal partially "paid for" the reduction in personal income tax rates by taxing capital gains at the same rates applicable to other income. It is highly unlikely, however, that capital gains will recover in the near future to the 2006-2007 levels upon which the rate cuts were based, and capital gains fluctuate to a much greater extent than income from wages. Therefore, basing a reduction in the personal income tax rates on an uncertain revenue source – i.e., capital gains – is likely to further reduce state revenues.

According to the updated Office of Revenue Analysis data, taxpayers reporting some capital gains income pay \$38 million more income tax annually under the Workgroup's proposal while taxpayers reporting no capital gains income at all pay \$78 million less. Obviously, if the former group of taxpayers ends up paying less in the future because capital gains realizations do not reach their historic 2006-2007 levels by FY12, when the proposal begins affecting state revenues, the net revenue loss will be even greater.

To further complicate matters the onset of these revenue losses will occur as federal stimulus funds are being exhausted, presenting the state with double "fiscal jeopardy."

INEFFECTIVE POLICY

Cutting income taxes is not a cost-effective means of promoting economic development and could actually be counter-productive. Proponents of reforming Rhode Island's personal income tax claim that high marginal tax rates on upper-income taxpayers deter business leaders from moving to Rhode Island and harm the state's economic development and job growth. But research shows that personal income tax cuts are not a cost effective strategy for promoting job growth.

In his minority report workgroup member Michael Mazerov cites numerous studies by economists that provide evidence that tax cuts are not a cost effective strategy for growing jobs or state economies.⁵ Many other studies come to similar conclusions:

- One study found that states that enacted significant tax cuts in the late 1990s and the early part of this decade fared worse in terms of job growth, personal income and employment, on average, than other states.⁶

- From 1994-1996, New Jersey cut personal income tax rates by 30 percent as an economic development strategy, providing researchers with a clear case study to evaluate the effects of personal income taxes on regional job growth. A 2004 study found that New Jersey experienced no additional job growth compared to neighboring New York and Pennsylvania.⁷

- A 1999 study by the Institute for Taxation and Economic Policy found that high income tax states experienced more rapid economic growth than states with low income taxes during the 1980s and 1990s.⁸

- A 2005 study by Dr. Andrew Leigh analyzed data from all 50 US states from 1977-2002 to assess the impact of progressive personal income taxes on migration and income distribution. The author concluded that "redistributive state taxes do not have a significant impact on interstate population flows."⁹

¹ Memorandum to Gary S. Sasse, Director, Departments of Administration and Revenue, from Paul L. Dion, Chief, Office of Revenue Analysis, April 1, 2009.

² RI Division of Taxation, Testimony to Revenue Estimating Conference May 2009

³ One must say on “on the order of 50 percent” because the two figures are not directly comparable. The estimated revenue loss from the flat tax option is based on the assumption that the flat tax had been fully phased in for tax year 2006. The estimated revenue loss from the Workgroup proposal as compared to a fully-phased-in flat tax is based on the assumption that both had been put in place in tax year 2007. In addition, the models used to prepare the two estimates are not identical.

⁴ Donald J. Boyd and Lucy Dadayan, “State Tax Revenue Falling Sharply in Fourth Quarter, Early Data Show,” State Revenue Report Number 74, Nelson A Rockefeller Institute of Government, January 2009, p. 19.

⁵ Report of the Governor’s Tax Policy Strategy Workgroup, March 2009. Dissenting Report of Workgroup Member Michael Mazerov, Senior Fellow, Center on Budget and Policy Priorities, Washington, D.C.

⁶ Brian Filipowich and Nick Johnson, “Tax Cuts and Continued Consequences: States that Cut Taxes the Most During the 1990s Still Lag Behind”, Center on Budget and Policy Priorities, December 19, 2006.

⁷ WR Reed and CL Rogers, Tax Cuts and Employment in New Jersey: Lessons from a Regional Analysis, Public Finance Review, May 2004.

⁸ Institute for Taxation and Economic Policy, “High Income Tax States Have Strong Economies,” December, 1999.

⁹ Andrew Leigh, “Can Redistributive Taxes Reduce Inequality?” Center for Economic Policy Research, Australian National University, Discussion Paper 490, April 2005.