

TAXFACTS:

IMPROVING EQUITY, ADEQUACY AND EFFICIENCY IN RHODE ISLAND'S TAX STRUCTURE

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State taxes are collective investments we make to create a quality of life in Rhode Island for all citizens. In order to make Rhode Island a first-class place to live and do business, we must ensure that our current and future workforce is educated, our bridges and roads are safe, our shorelines are clean, our communities are protected, and our neighbors have access to affordable housing and health care. A state's ability to provide the vital services needed to meet these goals is directly linked to the soundness of its tax system.

There are several fundamental principles that should be present in a sound tax system, including equity, adequacy and efficiency. Taxes are equitable if citizens are asked to contribute to the cost of public goods and services based on their ability to pay. An adequate tax system raises enough money, in the short run and long run, to finance public goods and services. An efficient tax system is one that maximizes revenue by including all available sources and not giving preferential treatment to certain groups.

Currently Rhode Island's tax system falls short on these three measures. There are several tax policy changes that should be undertaken to improve equity, adequacy and efficiency in Rhode Island's tax structure. These include:

- Repeal the "Flat Tax"
- Tax Long-term Capital Gains Income as Ordinary Income
- Mandate Combined Reporting
- Improve the Tax Expenditure Report
- Expand the Sales Tax Base

Rhode Island's Tax Structure is Inequitable

Rhode Island's tax system is inequitable because it requires low- and modest-income taxpayers to contribute larger shares of their incomes to taxes than upper-income households. As the following chart shows, in 2007 the poorest fifth of taxpayers — households with annual income of less than \$17,000 — paid 12.3 percent of their incomes in state and local taxes. The wealthiest one percent of Rhode Islanders — whose average income was \$1.2 million — paid 5.7 percent. Relative to their incomes, the most affluent Rhode Island residents pay less than half as much in taxes as the poorest Rhode Islanders (see *Chart 1, next page*).

Rhode Island's Tax Structure is Inadequate

Rhode Island's tax structure is also inadequate as evidenced by a growing structural deficit. The state's Fiscal Year 2009 deficit was just over \$460 million, representing approximately 11 percent of the general fund. The Governor's Budget Office Five Year Forecast projects that Rhode Island's deficits will continue to grow (see *Chart 2, next page*)¹

Annual budget shortfalls are partly the result of tax cuts enacted over the last decade, many in the name of economic development. These policies have cost hundreds of millions of dollars, crippling the Ocean State's ability to fund the public services that employers and workers rely on.

During the late 1990s, the personal income tax rate was cut from 27.5 percent to the equivalent of 25 percent of federal tax liability, costing the state \$100 million annually. The motor vehicle excise tax was also reduced at the local level. To protect municipalities from the loss of revenue, the state is reimbursing cities and towns at a cost of approximately \$140 million a year. Local communities are also being reimbursed for revenue lost to the phase out of the property tax on business inventories. This reimbursement costs the state \$100 million annually.

During the early part of this decade, a new crop of tax cuts and credits were enacted, costing the state tens of millions of dollars each year. These items included the motion

Chart 1. Low-Income Rhode Islanders Pay Larger Share of Income in Taxes, 2007

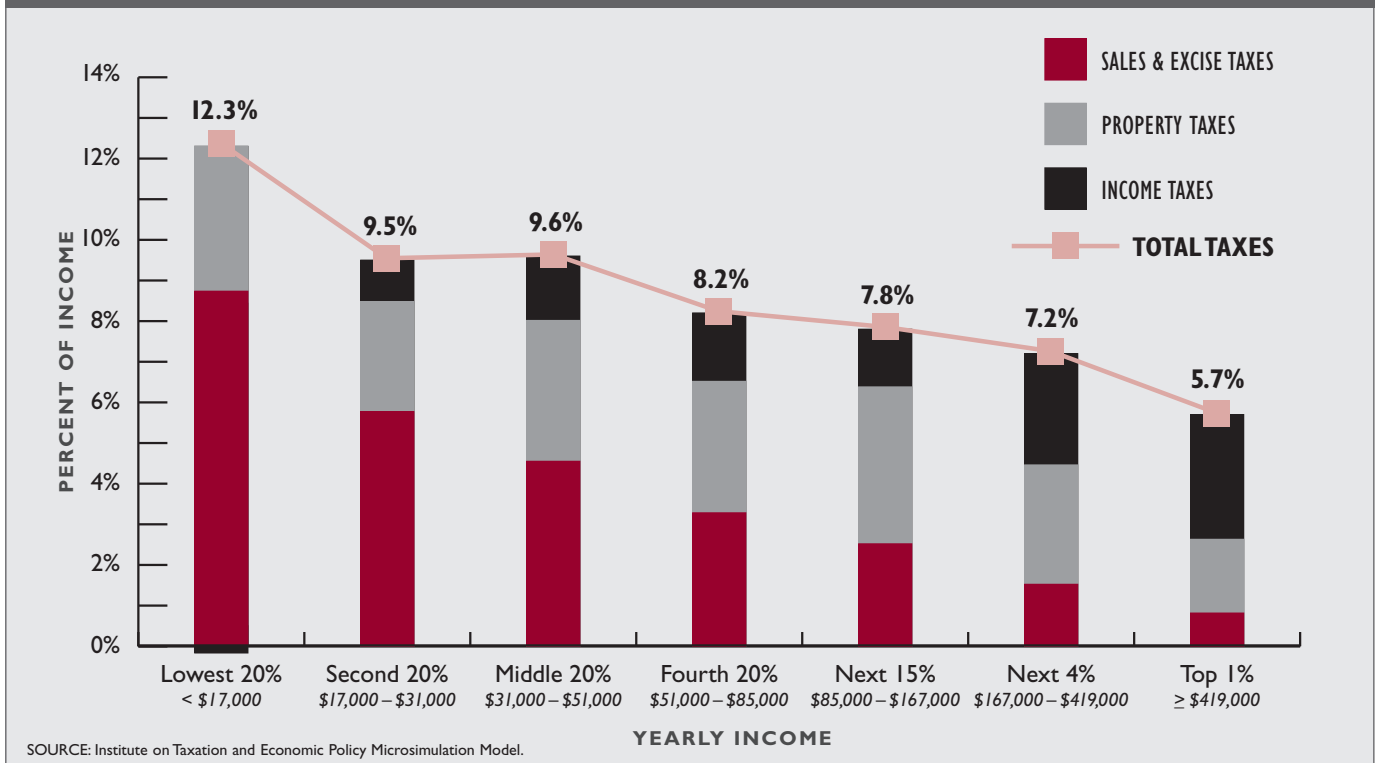
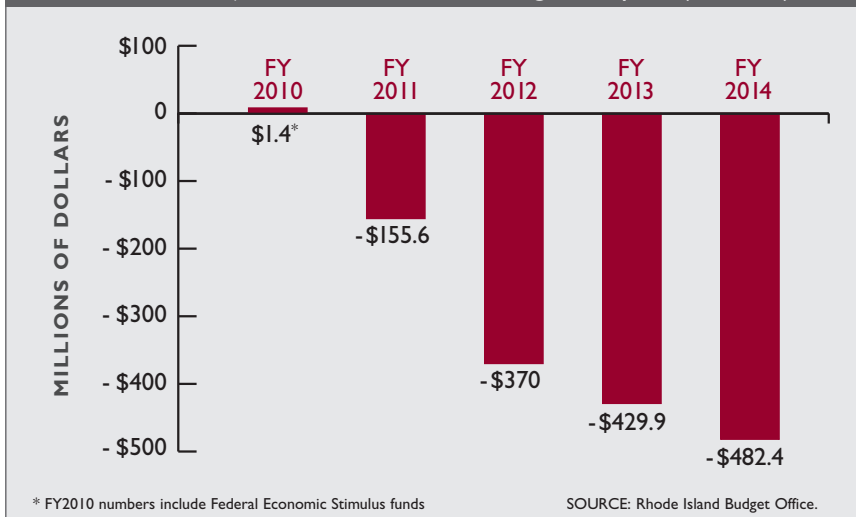


Chart 2. Projected Rhode Island Budget Surplus (Deficits)



Rhode Island's Tax Structure is Inefficient

Several important taxes in Rhode Island's income portfolio do not realize their full potential or yield the amount of revenue they could because of the favorable treatment they receive or items they exclude. Jeff McLynch of the Institute on Taxation and Economic Policy cites the following inefficiencies:²

- Within the *personal income tax*, Rhode Island is one of only nine states to offer a substantial tax break for capital gains income, despite evidence that such preferences do not spur economic growth.

picture tax credits, historic preservation tax credits, and the shift to a double-weighted sales apportionment formula for manufacturers.

Finally, policymakers enacted the alternative "flat tax" and cut capital gains taxes based on the premise that they would attract and retain wealthy taxpayers. In Fiscal Year 2009, these two items are estimated to be causing the state to forgo more than \$60 million in revenue.

- Rhode Island's *corporate income tax* is vulnerable to a wide variety of tax avoidance schemes that aim to shift income out of Rhode Island and into states where it is either taxed at lower rates or not at all; these schemes are the very definition of inefficiency, as they generally have no economic substance behind

them. As a result, Rhode Island's corporate income tax base fails to reflect the true level of economic activity occurring within the state's borders.

- The **sales tax** base in Rhode Island is largely limited to tangible goods, even as services have come to constitute a substantially larger share of consumption. According to a 2004 study conducted by the Federation of Tax Administrators, Rhode Island taxes only 29 out of a possible 168 services. Consequently, to yield an equivalent amount of revenue, Rhode Island must impose a higher sales tax rate than if it used a more comprehensive sales tax base.

Five Ways Rhode Island Can Improve Tax Equity, Adequacy and Efficiency

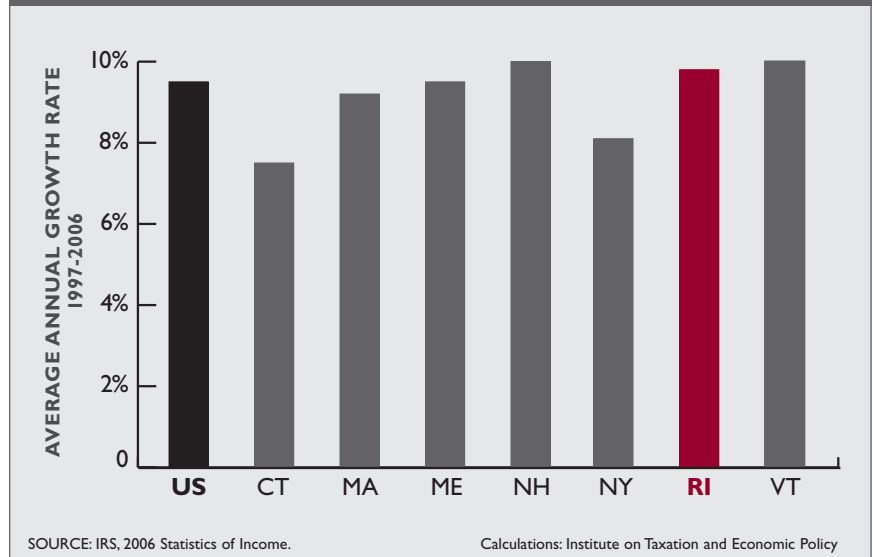
There are several policy changes that should be undertaken to help raise adequate revenues and to restore equity and efficiency to Rhode Island's tax structure.

Repeal the Alternative Flat Tax The General Assembly enacted the alternative "flat tax" in 2006. This allows taxpayers the option of paying either the current personal income tax rates (which range between 3.75 percent and 9.9 percent depending on income) with all deductions and credits, or to apply a flat tax rate to their federal adjusted gross income, without deductions or credits. In tax year 2009, the flat tax rate is 6.5 percent and will drop to 5.5 percent by tax year 2011. A relatively small number of wealthy households benefit from the flat tax. Repealing this tax could allow Rhode Island to recapture revenues and maintain a progressive tax structure.

This policy was enacted based on the premise that cutting income taxes for high-income taxpayers would prevent wealthy taxpayers from leaving the state, and also attract those individuals capable of creating jobs to help grow our economy. Yet, evidence from the Statistics of Income shows that prior to the enactment of this policy, the argument that Rhode Island's wealthy residents were fleeing the state was unfounded. Between 1997 and 2006, the first year the flat tax was implemented, the number of high income tax-

payers in Rhode Island and the amount they earn grew in line with regional and national trends. In fact, Rhode Island outpaced its neighbors Massachusetts and Connecticut on this measure (see *Chart 3*).

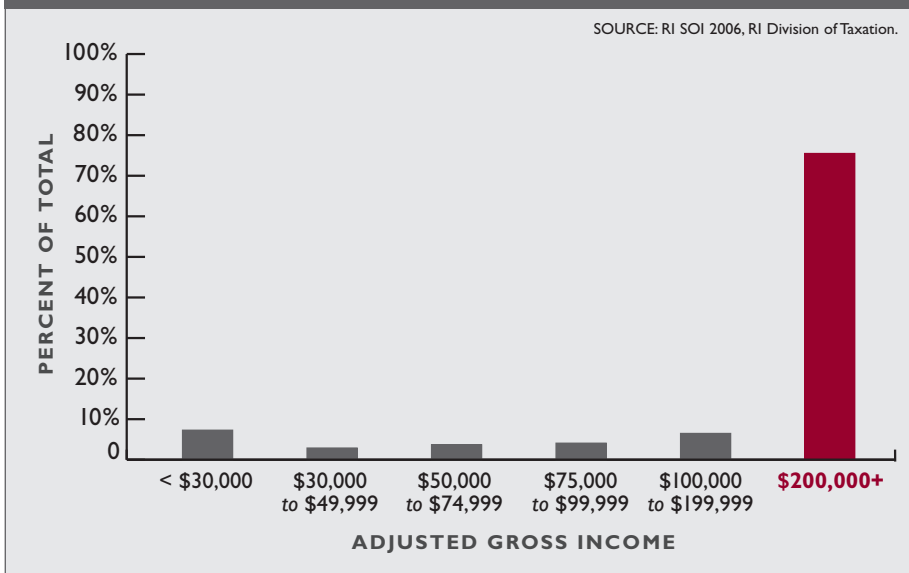
Chart 3. Percentage of Growth of High-Income Taxpayers in Rhode Island Mirrors Rest of Region



Further, proponents are wrong that Rhode Island needs the flat tax to encourage the rich to invest in jobs. In numerous studies, economists warn that individual tax cuts³ are not a cost-effective tool for growing state economies. Economic studies find little relationship between job growth and tax cuts. According to one study, this is particularly true for taxes on individuals, including the personal income, sales, and residential property taxes.⁴ In fact, the literature on the impact of cutting taxes on economies warns that the substantial loss of revenue is more likely to harm a state's competitiveness by negatively impacting its ability to finance vital public services that businesses have come to rely on and expect.⁵

Repealing the flat tax would improve the equity and adequacy of our tax structure. The amount of revenue being lost to the flat tax is unaffordable and benefits only a small number of wealthy taxpayers. In tax year 2011, the state will be losing \$76 million annually in revenue to the flat tax. Yet only 13,990 taxpayers will benefit from this option, the vast majority of whom are earning more than \$200,000 a year and close to 45 percent (or 6,069) of whom will be non-residents (see *Chart 4, next page*).⁶

Chart 4. Three-quarters of Flat Tax Users Earn Over \$200,000



sells Rhode Island real estate that has been held longer than five years and results in a capital gain, they will pay the lower tax rate in Rhode Island but will end up owing tax in their home state as well. While the filer will be credited for the taxes paid to Rhode Island, because Massachusetts and Connecticut tax capital gains at higher rates, those filers will pay additional taxes to their own state. If Rhode Island's tax rates were at rates comparable to Massachusetts and Connecticut, the filer would pay the same amount, but Rhode Island would receive all of the tax liability owed.

Tax Long-term Capital Gains as Ordinary Income

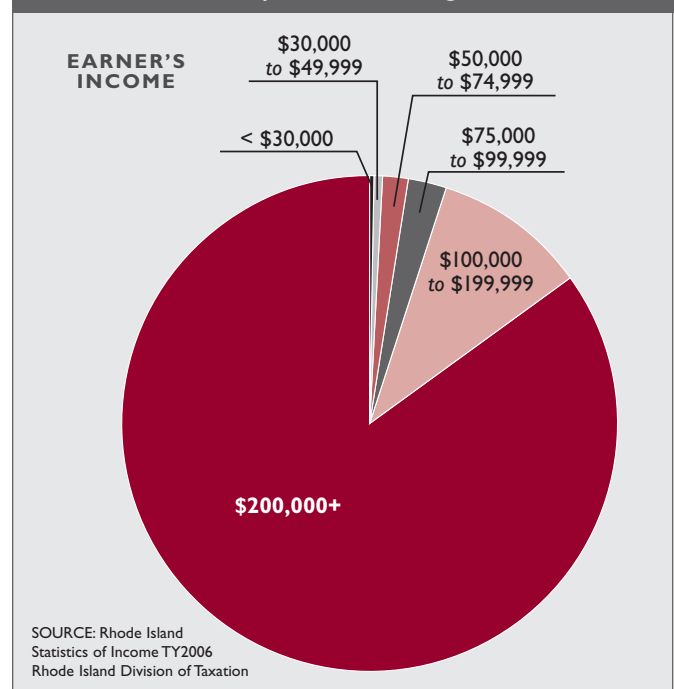
Capital gains income comes from the sale of an asset such as stocks, bonds, art and collectibles, and investment real estate. Rhode Island currently taxes long-term capital gains well below the rates for "ordinary" income such as wages and salaries. In fact, Rhode Island is only one of nine states that offers significant tax breaks on capital gains income generated from the sale of long-term assets. The remaining states that levy an income tax generally tax capital gains income as ordinary income, the same as wages.

Like the flat tax, the majority of taxpayers benefiting from these preferential rates are a relatively small number of taxpayers earning more than \$200,000 a year.⁷ According to the Rhode Island Statistics of Income, in 2006 close to 85 percent of capital gains tax collections were paid by those taxpayers earning more than \$200,000 a year. This was up from 80.4 percent the previous year.

Taxing capital gains as ordinary income improve tax equity. In fact, in its 2009 report the Governor's Tax Policy Workgroup recommended eliminating preferential tax rates for capital gains as part of a package of proposed changes to the state's tax structure, noting that such a change would "treat all sources of income equally and provide increased vertical equity in the tax system."⁸

The state's preferential rates on capital gains also present inefficiencies in Rhode Island's tax system, in part due to non-resident filers. If a Connecticut or Massachusetts resident

Chart 5. Rhode Island Capital Gains Collections 2006 – 85% Paid by Those Earning Over \$200,000



Furthermore, although Rhode Island's tax cut on capital gains was enacted in the name of economic development, several studies have found that capital gains tax cuts are a particularly ineffective tool in stimulating economies. For example, in 2002 the Congressional Budget Office analyzed tax cuts and their effect on the economy and found that capital gains tax cuts were among the *least* effective in boosting economic activity.⁹ Another study by the Director

of the Tax Policy Center of the Brookings Institution – Urban Institute partnership found no significant relationship between capital gains tax rates and economic growth.¹⁰

Finally, capital gains tax cuts are unaffordable given the enormity of the state's deficit. The Rhode Island Division of Taxation testified at the November 2008 Revenue Estimating Conference that the revenue lost because of the reduced tax rates totaled \$26.8 million. The preferential tax treatment of capital gains contributes to the state's structural deficit and long-term financial problems.

Restoring capital gains tax rates can help position the state to strengthen its revenue stream when the economy eventually recovers, improve tax fairness, and eliminate inefficiencies in Rhode Island's tax structure.

Mandate Combined Reporting for Multi-state Corporations

The goal of the state's corporate income tax is to ensure that Rhode Island's corporate citizens pay their fair share towards the public services and infrastructure they use every day, including roads and bridges, police, fire and rescue, and a public education system that trains current and future workers.

Rhode Island Business Corporations Tax raised \$151.4 million in FY2008, accounting for 4.4 percent of the state's General Revenues. Although Rhode Island's statutory rate on corporate income is nine percent, few firms pay this amount because of the deductions, credits and exemptions allowed. In 2006, Rhode Island ranked 26th in corporate taxes collected as a share of state personal income.¹¹ During that year, 47,048 (93 percent) of the 50,605 Rhode Island corporate taxpayers paid the "minimum tax" of \$500 a year.¹²

Rhode Island policymakers wisely closed two commonly used corporate loopholes known as "passive investment companies" and "captive real estate investment trusts" in 2007. While critical steps in corporate tax reform, they are not the only loopholes that corporations can take, leaving Rhode Island among a minority of states that has left the doors open for the use of aggressive tax avoidance schemes. The state has an opportunity to shut down most of these practices once and for all by enacting combined reporting.

Combined reporting requires that a corporation add together profits from the parent company and any in-state and out-of-state subsidiaries. The combined profits are then divided for tax purposes among the states in which the company does business in proportion to the level of business activity conducted in each state.

Twenty three of the forty five states that levy a corporate income tax now require combined reporting by multi-state corporations, including our northeast neighbors Massachusetts, New York, Vermont, New Hampshire, and Maine.

Opponents of combined reporting say it will harm the state's business climate. According to the Center on Budget and Policy Priorities, however, between 1990 and 2007, seven of the eight states with corporate income taxes that had net gains in manufacturing employment were combined reporting states (*AZ, ID, KS, MT, NE, ND, and UT*).

The Rhode Island Division of Taxation analyzed the impact of combined reporting in Rhode Island. Based on a sampling of businesses, they found that of the businesses now paying taxes in Rhode Island, nearly three-quarters would not be impacted or would see a tax decrease. Twenty-eight percent would have a tax increase.¹³

The Division of Taxation estimates that combined reporting would generate an additional five to eight percent of business corporation tax revenue in Rhode Island. The current FY2010 estimate for this tax is \$110.8 million. Therefore, an additional \$5.5 million to \$8.9 million would be generated at the current tax rate.

Instituting combined reporting would also be an important step in leveling the playing field between multistate and locally-owned and -operated businesses. Tax avoidance schemes give large companies the advantage of boosting their after-tax income and thus their ability to undercut prices of smaller, in-state businesses. Paying little or no income tax also allows large corporations to attract new capital at a lower cost.

Improve the Tax Expenditure Report and Include as Part of the State Budget

Tax expenditures are tax credits, deductions, exemptions, exclusions and preferential rates that reduce the tax liability for selected firms or individuals.

Essentially tax expenditures represent state spending through the tax code.

Tax expenditures are similar to direct spending programs in that they expend public funds to accomplish policy goals. Unlike direct spending programs, however, tax expenditures become permanent provisions of the tax code and can continue indefinitely. They are not included as part of the annual budget appropriations process and therefore receive much less scrutiny from both inside and outside government.

A Tax Expenditures Report (TER) documents the amount of revenue the state forgoes to tax expenditures. It is an extremely important, yet often overlooked, budget document. A meaningful tax expenditures report can give both policymakers and the public a more complete picture of the state's finances and an opportunity to evaluate whether or not tax policies are achieving their intended goals and/or are cost effective.

Rhode Island's Tax Expenditures Report needs to be improved. The Center on Budget and Policy Priorities' recent report "Promoting State Budget Accountability through Tax Expenditure Reporting" found the Rhode Island's TER to be among the least useful in the country because it omits certain taxes and fails to provide cost estimates and other vital information about many tax expenditures.¹⁴ The Poverty Institute's analysis of the 2008 Tax Expenditures Report found that 118 out of the 211 listed expenditures could not be reliably estimated by the Division of Taxation.¹⁵

A more accurate, timely and comprehensive Tax Expenditure Report will allow lawmakers an opportunity to conduct a cost benefit analysis of the state's tax expenditures and the options available for balancing the state's budget. The report should be improved by requiring that it:

1. Be published annually and included as part of the budget submission,
2. Provide historical data and future projections of revenue forgone for each tax expenditure,
3. Include a stated purpose for each tax expenditure and determination as to whether the item is achieving its stated purpose,
4. Show the distribution of each tax expenditure's benefit by income level or company size, and

5. Provide information about implicit tax expenditures: such as the total revenue forgone from excluding certain services from the sales tax base, exempting certain property from local taxation, and conforming state taxes to federal tax laws.

Enacting these important changes can help policymakers determine whether limited resources are being used in the most effective way possible and whether certain tax expenditures should be maintained, reformed, or eliminated.

NOTE: In 2008, the General Assembly created legislation requiring greater disclosure and accountability of six tax credits. The legislation required that information about these tax credits be released in three phases.

Phase One, released in September 2008 by the Department of Revenue, listed names and addresses of the corporations and the amount of the tax credits received during the previous fiscal year.

Phase Two is intended to provide comprehensive information regarding the costs and benefits of the credits. The Division of Revenue is required to issue a report that includes the following for each recipient and each category of tax credit: 1) name of each recipient; 2) dollar amount of each tax credit; 3) summaries of the number of full-time and part-time jobs created or retained; 4) employee benefits provided; 5) the degree to which job creation and retention, wage and benefit goals and requirements have been met; 6) aggregate dollar amounts for each category of tax credit and for each geographical area within the state; and 7) number of recipients within each category. This was due on October 15, 2008.

Phase Three requires the Director of the Department of Revenue to present information to the General Assembly on the costs of the tax credits that includes the cost to the state during the preceding fiscal year; an estimate of the anticipated costs in future years including the fiscal year of the requested budget; and the extent to which any employees of and recipients have received Rlte Care or Rlte Share benefits or assistance and the impact that any such benefits or assistance have on the state budget. This was due in January of 2009.

As of May 2009 neither Phase Two or Phase Three of the reporting process had been completed.

Expand the Sales Tax Base to Include Services The sales tax in Rhode Island is 7 percent. The tax base, however, is largely limited to tangible goods, even as services have come to constitute a substantially larger share of consumption. As of 2007, services constituted 60 percent of consumption nationwide; yet, according to a 2004 study by the Federation of Tax Administrators, Rhode Island taxed just 29 out of a possible 168 services.

Rhode Island's sales tax raised \$854.4 million in FY2008 and is projected to total \$831.0 million in FY2009. Bringing the sales tax into the 21st century by taxing services could raise hundreds of millions of dollars in new revenue and make Rhode Island's sales tax more stable – as it would protect the state against any further shift from consumption to services.

Any expansion of the sales tax base, however, must be combined with policies that will help preserve progressivity in the tax structure. Broadening the sales to a wider array of items and services should be coupled with an enhancement to the state Earned Income Tax Credit (EITC) in order to protect low- and modest-income households against the regressive nature of this tax.

- ¹ "Five Year Financial Projection", State of Rhode Island Budget Office.
- ² *Achieving and Equitable, Efficient and Competitive Tax System in Rhode Island* Memorandum to Governor Carcieri's Tax Policy Workgroup from Jeff McLynch, Northeast Regional Director of the Institute on Taxation and Economic Policy, October 23, 2008.
- ³ 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.
- ⁴ Stephen T. Mark, Therese J. McGuire, and Leslie E. Papke, "The Influence of Taxes on Employment and Population Growth: Evidence from the Washington, DC Metropolitan Area," *National Tax Journal*, March 2000.
- ⁵ Robert G. Lynch, *Do State and Local Tax Incentives Work?* *Economic Policy Institute*, Washington, DC 1996.
- ⁶ RI Division of Taxation, *Testimony to November 2008 Revenue Estimating Conference*
- ⁷ Source: RI Statistics of Income, TY 2006, RI Division of Taxation
- ⁸ Report of the Governor's Tax Policy Strategy Workgroup, March 9, 2009
- ⁹ Congressional Budget Office, *Economic Stimulus: Evaluating Proposed Changes in Tax Policy*, Washington, D.C. January 2002.
- ¹⁰ Burman, Leonard and Kravitz, Troy, "Capital Gains Tax Rates, Stock Markets, and Growth", *Tax Notes*, November 7, 2005
- ¹¹ Source: Bureau of Economic Analysis; Bureau of the Census
- ¹² Report of the Governor's Tax Policy Strategy Workgroup, March 9, 2009
- ¹³ Report to the General Assembly on Combined Reporting of Corporate Income Tax, RI Department of Revenue, Division of Taxation, December 2008.
- ¹⁴ Jason Levitis, Nicholas Johnson, and Jeremy Koulisch, "Promoting State Budget Accountability through Tax Expenditures Reporting," *Center on Budget and Policy Priorities*, April 2009
- ¹⁵ "Tax Facts: 2008 Tax Expenditures Report Analysis" The Poverty Institute, June 2008.



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