

I. Introduction

Tax expenditures are credits, deductions, exemptions, exclusions or preferential tax rates that reduce tax liability for selected firms or individuals. Tax expenditures are similar to direct spending programs in that they reduce available government funds to accomplish policy goals – for example, Rhode Island subsidizes research and development and adoption costs through tax credits. Unlike direct spending programs however, tax expenditures become permanent provisions of the tax code and are not part of the annual appropriation process. Historically, Rhode Island did not routinely evaluate the effectiveness or cost of tax expenditures.

To correct this, the General Assembly required the Division of Taxation to publish a bi-annual Tax Expenditures Report which estimates the cost of 212 “tax preference items” or tax expenditures (RIGL 44-48.1-1). This paper analyzes the data provided in the 2006 Tax Expenditures Report.

In 2005, Rhode Island lost at least \$1.4 billion in tax revenue as a result of various tax expenditures. However the Division of Taxation was unable to estimate the costs of 127 items, so the true impact of tax expenditures on state revenues is undoubtedly much higher than \$1.4 billion.

For many tax expenditures enacted as economic development strategies—such as credits and exemptions for investment firms, banks, computer executives and international trading firms—no reliable estimate of costs was made.

Other economic development incentives have proven highly expensive to the state. “Passive investment treatment” enacted in 1994 cost the state \$39.1 million in revenue in 2005. Exempting aircraft from the state sales tax cost \$1 million. In these and other cases, no assessment has been made as to the effectiveness of these incentives in spurring job growth and development.

The 2006 Tax Expenditures Report also estimates the costs of numerous costly exemptions from the sales tax and deductions from the personal income tax which, in a tight budget year, should be carefully evaluated as to purpose and impact.

II. Findings

In January, the Division of Taxation published its bi-annual Tax Expenditures Report which estimates the revenue foregone from any of 212 credits, adjustments, exemptions, deductions, and rate reductions that reduce a taxpayer’s state tax liability. The Poverty Institute analysis of the 2006 Tax Expenditures Report finds that:

1. The state lost potential revenue of at least \$1.4 billion in 2005 as a result of tax expenditures.
2. Half of this amount (\$690 million) was attributable to deductions, exemptions and credits against the personal income tax. Most of these arise from Rhode Island’s “piggy-backing” on the federal income tax.
3. The Division of Taxation was unable to reliably estimate the foregone revenue from sixty percent of tax expenditures. Thus the true cost of Rhode Island’s tax expenditures must be considerably higher than \$1.4 billion.
4. Many tax preference items that were enacted to promote economic development or job creation can not be reliably estimated. These include:
 - a) Exclusion of income from stock options in computer companies.
 - b) Exclusion of income from employee ownership in qualifying businesses.
 - c) Exemption of boats from the sales tax.
 - d) Exemption of art work from the sales tax.
 - e) Exemption of investment companies’ toll free calls from the sales tax.
 - f) Special treatment of international investment services, investment and security firms, domestic international sales companies (DISCs) and foreign sales companies (FSCs) from the sales tax.
 - g) Exemption of motion picture production firms from sales taxes.
 - h) Exemptions from the bank excise tax.
 - i) Exclusion of dividend and interest income from the business corporation tax.
 - j) Interest, wage and investment credits for owners of mill buildings.

5. When the cost of tax expenditures can be reliably estimated, the foregone revenue is often substantial, yet no information exists to allow policymakers to assess whether the expenditure has generated equivalent benefits for the state. For example:

- a) The state of Rhode Island forewent \$39.1 million in corporate tax revenue as a result of “passive investment treatment.” This tax expenditure exempts income earned by managing intangible assets from the corporate income tax (RIGL 44-11-1 (1)-(vii)).
- b) The state foregoes \$24 million in revenue each year in licensee commissions for Jai Alai, Simulcast and Pari-Mutuel betting.
- c) In 2005, the state lost \$1 million by exempting aircraft from the sales tax, an exemption that supporters argued would create jobs in aircraft repair and maintenance.
- d) Tax credits for historic structures cost the state \$33 million in the 2005 tax year.
- e) Tax credits for investment and enterprise zones cost the state \$9.8 million in 2005, yet a 2003 study by economist James Medoff for the RI Economic Development Corporation concluded that these tax incentives were ineffective as economic development strategies.

Rhode Islanders pay, on average, 11.1 percent of their personal income in state and local taxes. For state and local governments to recoup the \$106.9 million in revenue lost from all the above items, the firms involved would need to generate an additional \$963 million in annual income or create 27,234 full-time, year round jobs paying the average RI wage of \$17/hour.

6. Many tax exemptions and deductions are quite costly

- a) If Rhode Island disallowed most federal itemized deductions to the personal income tax, as Massachusetts does, the state would have collected an additional \$115.7 million in 2005. According to the IRS, 98 percent of taxpayers with incomes above \$200,000 itemized deductions, while only 30 percent of taxpayers with incomes below \$200,000 itemized in 2003.
- b) Exempting newspapers from the sales tax cost \$5.2 million in foregone revenue. Yet newspapers are not a consumer necessity and subjecting newspapers to the sales tax is unlikely to shift purchases across the border.

c) Exempting clothing and footwear from the sales tax cost \$82.4 million in foregone revenue in 2005. Yet studies show that exempting clothing from the sales tax does not primarily benefit lower-income consumers.

III. Summary of 2006 Tax Expenditures Report

Rhode Island state government lost at least \$1,442 million in revenue in 2005 as taxpayers and corporations took advantage of any of 212 “tax preference items” – credits, exemptions, deductions that reduce state tax liability. This is almost certainly an underestimate, since the Division of Taxation was unable to reliably estimate the cost of 127 items – 60 percent of the tax expenditure items covered in the report.

Table 1 – 2006 Tax Expenditure Report Results Summary

Category	Number of Tax Preference Items	Number of Items Not Estimated	Estimated Revenue Foregone
Personal Income Tax	35	17	\$690,390,084
Sales and Use Tax	79	48	\$578,763,700
Business Corporation Tax	25	23	\$77,700,000
Miscellaneous Taxes and Fees	47	31	\$44,871,965
Preference Items for More than One Tax	26	8	\$50,168,899
TOTAL	212	127	\$1,441,894,648

Personal Income Tax: Estimated Cost = \$690 million

Just under half of the estimated revenue foregone in 2005 is due to preference items for the personal income tax. Because Rhode Island has historically “piggybacked” on the federal income tax, all deductions, exemptions and credits allowed on federal tax forms are also allowed in Rhode Island, at a cost of \$683 million in 2005. These include personal exemptions, itemized and standard deductions, deductions for IRA and Keogh contributions, and credits for child care. Another \$6 million in personal income tax revenue was foregone for property tax relief in 2005.

No estimates were provided for 17 of the 35 preference items for the personal income tax (49 percent). Items not estimated include exemptions for artists (RIGL 44-30-1.1 and 44-30-24), exclusion of stock options in computer companies (RIGL 44-39.3-1) and exclusion of income from employee ownership in a qualifying corporation (RIGL 44-43-8).

Table 2 – Major Estimated Personal Income Tax Items in 2005

Personal Income Tax Preference Items	Estimated Revenue Foregone
Credit for Other States' Taxes	\$114,722,434
Credit/refund Property Tax Relief	\$6,000,000
Federal Adjustment – Self-employment	\$2,500,000
Federal Adjustment – Self-employed Health Insurance	\$4,700,000
Federal Adjustment – Keogh Plan and SEP	\$4,300,000
Federal Deduction – Standard	\$286,900,000
Federal Deduction – Itemized	\$115,700,000
Federal Credit – Child/Dependent Care	\$2,446,000
Federal Credit – Foreign Taxes	\$5,410,000
Federal Credit – Earned Income	\$4,346,000

Table 3 – Major Estimated Sales Tax Exemptions

Sales Tax Preference Item	Estimated Revenue Foregone
Newspapers	\$5,200,000
Containers	\$18,400,000
Gasoline	\$61,000,000
Food Products	\$120,000,000
Medicines & Drugs	\$22,300,000
Motor Vehicles to Non-Residents	\$6,200,000
Coffins, Caskets & Burial Garments	\$2,200,000
Nursing Home/Hospital Rental Charges	\$136,000,000
Educational Institutions Rental Charges	\$18,300,000
Heating Fuel for Residences	\$21,000,000
Electricity & Gas for Residences	\$39,600,000
Manufacturer's Machinery & Equipment	\$8,300,000
Motor Vehicle Trade-in	\$15,200,000
Clothing & Footwear	\$82,400,000
Water for Residential Use	\$6,000,000
Textbooks	\$1,475,000
Food Stamp Items	\$5,100,000
Trucks, Buses in Interstate Commerce	\$1,800,000
Aircraft & Aircraft Parts	\$1,000,000

Sales and Use Taxes: Estimated Cost = \$579 million

Seventy-nine items are exempt from Rhode Island's sales tax. The Division of Taxation estimates that \$579 million in revenue was foregone in 2005 due to sales tax exemptions. Most (98 percent) of this was attributable to the nineteen items listed in Table 2.

No reliable estimates were provided for 48 of the 79 items (61 percent), including exemptions for boats and for investment companies' toll free calls.

Business Corporation Tax: Estimated Cost = \$77.7 million

The Division of Taxation provided reliable estimates for only 2 of the 25 preference items from the Business Corporation Tax. Allowing a deduction for net operating losses (a commonly accepted practice) reduced state revenue by \$38.6 million. Passive investment treatment exempting firms whose primary business involves managing intangible assets from the corporate income tax (RIGL 44-11-1 (1)-(vii)) reduced state revenue in 2004 by \$39.1 million.

No reliable estimates were provided for 23 of the 25 preference items (92 percent). Items not estimated include special provisions for investment and security companies, exclusion for DISCs, FSCs and international investment services.

Miscellaneous Preference Items: Estimated Cost = \$44.9 million

This category includes 47 preference items for 21 miscellaneous state taxes and fees. Among the most significant items are licensee commissions for Jai Alai, Pari-Mutuel and Simulcast betting. These three items resulted in \$24 million in lost revenue to the state.

Of 47 preference items, 31 had no reliable estimate (66 percent). Among the items not estimated were exemptions from the back excise tax.

Other Preference Items for More than One Tax: Estimated Cost = \$50.2 million

This category consists of 26 tax credits, exemptions, deductions and rate reductions that can be claimed against more than one tax (for example against personal income and corporate income). Most of these items provide tax incentives for economic development purposes.

Table 4 – Major Estimated Economic Development Incentives

Other Preference Items for More than One Tax	Estimated Revenue Foregone
Enterprise Zone Wage Credit	\$4,235,000
Investment Tax Credit	\$5,525,000
Educational Assistance Expense Credit	\$1,583,300
Job Development Rate Reduction	\$4,732,439
Credit for Historic Structures	\$33,007,384

The Division of Taxation was unable to reliably estimate the revenue foregone for eight of 26 preference items in this category (31 percent). Items not estimated include the motion picture production credit, deductions for hiring the unemployed or welfare recipients, and credits for investment in mill buildings.

IV. Conclusion

Rhode Island lawmakers have enacted numerous tax expenditures as an economic development strategy. The cost to the state in lost revenue is, in many cases, quite high. For example, the revenue foregone from passive investment treatment and from the various economic development incentives reported as “other preference items for more than one tax” total \$88.1 million in annual revenue losses. For state and local governments to recoup the losses from the various economic development tax incentives for which the Division of Taxation was able to provide reliable estimates, the firms taking these credits would need to generate \$1 billion annual income – or create 28,433 jobs paying the RI average wage of \$17/hour.

Since 1990, the Rhode Island economy generated 37,200 net new jobs. It is possible that most of these jobs were created as a result of economic development tax incentives. Yet Rhode Island lawmakers have not evaluated these incentives to assess whether jobs were, in fact, created and, if they were, whether this was a cost-effective strategy of job creation. For example, did foregoing \$24 million in licensee commissions create 7,229 full-time, year-round jobs at the median wage? Has the foregone \$39.1 million from passive investment treatment created 11,776 jobs? No analysis has been done of Rhode Island’s tax expenditures that would allow policy makers to answer such questions.

For example, did foregoing \$24 million in license commissions create 6,115 year-round jobs at the average wage? Has the foregone \$39.1 million from passive investment treatment created 9,961 jobs at the average wage? No analysis has been done of Rhode Island’s tax expenditures that would allow policy makers to answer such questions.

Table 5 – Economic Development Tax Expenditures

Economic Development Tax Incentive	2004 Revenue Lost	Annual income needed to offset revenue lost ⁱ	Number of full-time, year-round average wage jobs needed to recoup lost revenue ⁱⁱ
Enterprise Zone Wage Credit	\$4,235,000	\$38,153,153	1,078
Investment Tax Credit	\$5,525,000	\$49,774,774	1,408
Job Development Rate Reduction	\$4,732,439	\$42,634,585	1,206
Credit for Historic Structures	\$33,007,384	\$297,363,819	8,410
Aircraft and Aircraft Parts	\$1,000,000	\$9,009,009	256
Passive Investment Treatment	\$39,100,000	\$352,252,252	9,961
Licensee Commissions	\$24,000,000	\$216,216,216	6,115
TOTAL	\$111,599,823	\$1,005,403,808	28,433

ⁱ Since RI taxpayers pay, on average, 11.1 percent of their personal income in taxes, this column represents the revenue lost divided by 0.111.

ⁱⁱ This column is calculated by dividing the prior column by \$29,910, the median income for a full-time, year-round job in Rhode Island.