

OPTIONS FOR RAISING STATE REVENUES

For several years, Rhode Island policymakers have grappled with annual operating deficits and have justifiably been concerned with the structural imbalance between spending and revenues. Public debate on Rhode Island's recent budget deficits has focused almost exclusively on curbing state expenditures. Yet calculations by the Rockefeller Institute and the Center for Budget and Policy Priorities found that, from 1993-2003, Rhode Island had the sixth lowest rate of growth in state spending.¹ Clearly, if Rhode Island is to continue offering the quality government services that residents rely on, we need a fair assessment of both sides of the budget – expenditures and revenues.

This report proposes several areas where the state could start to address weaknesses in the revenue side of the ledger. By reforming tax credits, eliminating unproductive tax expenditures, closing corporate loopholes and broadening the sales tax base, policymakers could enhance equity and strengthen the state's long-term fiscal position. These proposals should be seen as the beginning of a longer-term effort to improve Rhode Island's revenue system.

REFORM TAX EXPENDITURES: The Tax Expenditures Report, published bi-annually by the Division of Taxation, documents the hundreds of millions of dollars in revenue foregone due to tax credits, deductions, and exemptions. Policymakers should thoroughly evaluate this "invisible budget" and end costly and ineffective tax expenditures. This report documents several tax expenditures that warrant action this year.

CLOSE ABUSIVE TAX LOOPHOLES: Businesses have grown more aggressive in using tax avoidance maneuvers which erode the state's corporate income tax. Policymakers should follow the lead of other states like Massachusetts and shut down these abusive tax shelters.

BROADEN THE SALES TAX: The shift to a service economy has reduced the base of Rhode Island's sales tax, which primarily taxes goods. Bringing the sales tax into the 21st century by taxing services could raise millions of dollars in new revenue.

RECONSIDER CHANGES TO THE PERSONAL INCOME TAX: Lawmakers have enacted several changes to the personal income tax including the elimination of the tax on long-term capital gain income and the enactment of an alternative flat tax for high-income filers. Rescinding the elimination of the capital gains tax and freezing the reduction in the alternative flat tax can protect tens of millions of dollars in revenue.

FREEZE THE PHASE-OUT OF THE MOTOR-VEHICLE TAX: A partial phase-out of the motor vehicle excise tax will cost \$139 million in FY 2007. Lawmakers should freeze further reductions in the motor vehicle excise tax.

I. Reform Tax Expenditures

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 government funds to provide services and accomplish policy goals. Unlike direct spending programs however, tax expenditures become permanent provisions of the tax code that are not subject to regular review through the annual appropriation process. Every two years, the Division of Taxation prepares a Tax Expenditure Report which shows the revenue foregone as a result of some of Rhode Island's tax expenditures.²

Many of these tax expenditures were enacted originally to promote economic development, but their economic impacts and affordability have never been assessed. In 60 percent of cases, the Division of Taxation is unable to estimate how much revenue is lost each year due to special tax treatment. Tax expenditures represent a huge invisible budget, where the state doesn't know how much it is spending or what it gets in return.

The following tax expenditures, for which there are good estimates of the cost, are quite expensive and need to be fully assessed to ensure that they are cost-effective means of achieving their purposes and are affordable in light of the overall budget.

Restructure the historic preservation tax credit.

The historic preservation tax credit was adopted in 2002 and allows developers to claim a tax credit equal to 30 percent of the cost of renovating an historic structure. (RIGL 44-33.2) Rhode Island imposes no cap on the project size or on the total amount of credits available in the state in a given year. Most observers agree that Rhode Island's historic tax credit has been extremely successful in promoting urban investment.

However, the costs to the state have become substantial and warrant review of the program. State fiscal analysts estimate that the historic tax credit may cost Rhode Island as much as \$85 million in lost revenue in FY 2008.

Currently 26 other states offer tax credits of some sort for historic preservation. Most limit the amount that can be claimed on any given project or cap the total cost to the state in a given year. At 30 percent of project costs, with no cap or project limit, Rhode Island's historic preservation tax credit is among the most generous and most costly in the nation.³

In 2005, Maryland, facing spiraling costs for its historic tax credits imposed a project cap of \$3 million and an annual spending limit of \$30 million so that developers would need to apply for the credit through a competitive bidding process.

By capping annual costs to the state, as was done in Maryland, Rhode Island could potentially save millions of dollars and target tax credits to important public purposes, like creating affordable housing, revitalizing disadvantaged neighborhoods or reclaiming brownfields.

Rhode Island could also save millions of dollars by developing a mechanism to reduce inefficiencies in the way credits are claimed. Currently, developers, who are unlikely to have any tax liability in Rhode Island, sell the credits to high-income state taxpayers who in turn reduce their own state tax liability. These deals are arranged privately and no data exist on the transaction costs involved in selling the credits. Anecdotal evidence, however, suggests that developers may receive as little as 70-80 cents for every \$1 in credits they sell. The other 20-30 cents goes to the buyers of the credits, to the brokers and lawyers who arrange the deals and to pay federal taxes. This means that the state spends \$1 to subsidize 70-80 cents in historical preservation costs. Much of this “slippage” could be eliminated if the state allocated historic preservation dollars directly to developers.

Reassess the motion picture tax credit.

In 2005, lawmakers enacted a tax credit for motion pictures produced in Rhode Island equal to 15 percent of production costs between \$300,000 and \$5 million and 25 percent of production costs above \$5 million. (RIGL 44-31.2) Confusion about the wording of the law prevented companies from using the credit until this year. Testimony to the November 2006 Revenue Estimating Conference suggest that the credit may cost the state as much as \$25 million per year.

Like the historic preservation credit, the motion picture tax credit places no cap on state liability or limits on production costs eligible for the credit. It therefore poses similar dangers to the state budget over the long term and its fiscal and economic impacts should be thoroughly assessed. Further, both Connecticut and Massachusetts have passed similar credits since Rhode Island's motion picture tax credit was enacted. This eliminates any competitive advantage Rhode Island may have had in trying to “jump-start” a local film production industry.

A recent report by the New England Public Policy Center evaluated the probable impact of motion picture tax credits in New England and concluded that such credits “cost sponsoring states a good deal in lost revenue” and that the “stimulus to economic activity appears to be rather modest.”⁴

The Louisiana Legislative Fiscal Office carried out a comprehensive economic impact study of that state's film tax credits and concluded that the economic benefits were small, so that states can expect to recoup only 16-18 percent of lost tax revenue due to expanded economic activity.⁵

Evaluate “passive investment treatment.”

According to the 2006 Rhode Island Tax Expenditures Report, 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)). It is not known which firms make use of this tax break or whether the lost

revenue translates into increased jobs and economic activity for the state. Lawmakers should not permit a tax expenditure of this magnitude to continue without thorough public review and disclosure of the economic and fiscal impacts.

Renegotiate licensee commissions.

The state also forgoes \$24 million in revenue each year in licensee commissions for Jai Alai, Simulcast and Pari-Mutuel betting. These substantial commissions to gaming facilities that operate within the state could potentially be renegotiated.

Eliminate ineffective economic development tax incentives.

Rhode Island offers numerous credits against the personal and corporate income tax for economic development. In 2003, the Rhode Island Economic Development Corporation commissioned a study by Harvard University economist James Medoff to assess some of these incentives. Medoff concluded that the state lacked adequate information to assess either the cost or the effectiveness of its economic development incentives. He also found that the Enterprise Zone tax credit (RIGL 42-64.6-6) and the Investment tax credit (RIGL 44-31), in particular, were not effective economic development tools. Together, these two credits cost the state \$9.8 million in 2005.

Eliminate sales tax exemptions for aircraft.

The sales tax on aircraft was eliminated in 2004 to encourage CEO's to relocate to Rhode Island. This exemption cost the state \$1 million in 2005, according to the 2006 Rhode Island Tax Expenditures Report. The exemption's impact on economic development and CEO location decisions has never been assessed.

II. Revive the Corporate Income Tax by Closing Loopholes

Rhode Island's Business Corporation Tax raised \$111.6 million in FY 2007, accounting for 3.5 percent of the state's general revenues. Although Rhode Island's statutory rate on corporate income is 9 percent, few firms pay this amount and Rhode Island ranks 46th in corporate taxes collected as a share of state personal income, dead last among the 46 states that levy such a tax.

Over the past decade, corporations operating in multiple states have made increasingly aggressive use of disparities in state corporate tax laws to avoid paying tax on corporate earnings. In 2002, the Multi-State Tax Commission estimated that Rhode Island was losing up to \$25 million each year due to its failure to close two common loopholes – the creation of “nowhere income”—income that escapes state taxation because of differences in state apportionment formulas—and the use of “passive investment companies” (PICs) to shift income to states where it will not be taxed at all.⁶ A recent study by the Federal Reserve Bank of San

Francisco concurred that “the non-uniformity in apportionment formulas and the use of passive investment companies likely have increased the share of federal taxable income that escapes state taxation altogether.”⁷

Enacting a “throwback” rule and disallowing the use of PICs would close these loopholes and end these abusive practices. A throwback rule could be fashioned to exclude sales to the federal government to minimize its impact on federal contractors operating in Rhode Island. From figures presented by the Tax Administrator in testimony to the House Finance Committee in 2005, The Poverty Institute estimates that these two reforms would raise approximately \$20 million in revenue annually.

III. Broaden the Sales Tax

Rhode Island’s 7 percent sales tax raised \$925 million in FY 2007, 29 percent of the state’s general revenues. Rhode Island’s sales tax ranked 35th in the nation in taxes collected as a share of personal income.

Over the past decades, the percentage of consumer dollars used to buy services rather than goods has increased substantially. In 2002, almost 60% of consumer spending purchased services, compared to only 44% in 1969. As the service sector becomes more important in consumer budgets, sales taxes, such as Rhode Island’s, that apply mostly to goods are in danger of being seriously eroded. According to the Center for Budget and Policy Priorities, Rhode Island’s sales tax applied to 37 percent of all sales in the state in 1990, but to only 34 percent of sales in 2003.⁸

The Center estimates that Rhode Island taxes only one “readily taxable” household service, cable TV, compared to an average of 15 in other states. Taxing all “readily taxable services” could increase Rhode Island’s sales tax revenues by up to one-third, according to the Center’s estimates.

According to the Institute for Taxation and Economic Policy, the lowest-earning fifth of Rhode Islanders paid 8 percent of their income in sales and use taxes in 2002, while the highest-earning one-percent of state residents paid only 0.8 percent of their income in sales taxes.⁹

Applying the 7 percent sales tax only to personal services (such as diaper services and dry-cleaning) and to such recreational activities as golf, marina and fitness membership dues would broaden the sales tax base and raise \$33 million in FY 2008. Since these services are purchased close to home and are consumed by relatively affluent households, such a tax would not be regressive and would not drive sales to bordering states.

IV. Reconsider Changes to Rhode Island’s Personal Income Tax

The personal income tax raised \$1,067 million in FY 2007 and accounts for 34 percent of Rhode Island’s general revenues. The state’s personal income tax is the most progressive of all state taxes, with graduated rates ranging from 3.75 to 9.9 percent. Rhode Island ranks 19th nationwide in personal income taxes collected as a share of state personal income.

Over the past several years, lawmakers have enacted several changes to the state’s personal income tax, including a 10 percent across-the-board reduction in rates, elimination of the tax on long-term capital gain income and the enactment of an alternative flat tax rate for high-income filers. The latter two changes were passed to make Rhode Island’s taxes competitive with Massachusetts. But Massachusetts now taxes capital gains and unearned income at higher rates than Rhode Island.

Rescind scheduled elimination of 5% tax on capital gain income.

In 2002, the General Assembly passed legislation to eliminate the tax on income from capital gains on assets held for more than five years. In tax year 2007, the tax rate on capital gains will fall to a maximum 1.67 percent, then to zero in tax year 2008. This legislation was passed in part to make Rhode Island competitive with Massachusetts which had eliminated its own tax on long-term capital gains. However, Massachusetts has since rescinded this law and now taxes long-term gains at 5.3 percent. Rhode Island currently taxes capital gains at a maximum rate of 5 percent.

In tax year 2004, Rhode Islanders reported \$1.6 billion in capital gains income to the IRS. Taxpayers earning \$200,000 or more received 78 percent of all capital gain income. Assuming half of this income was from assets held more than five years, eliminating the five percent tax on capital gains could cost Rhode Island \$26.4 million in tax year 2007 and \$40 million in tax year 2008. Virtually all benefits will accrue to the highest earning 1.9 percent of taxpayers.¹¹

Freeze the alternative flat tax.

The General Assembly enacted the alternative flat tax in 2006. The legislation will allow taxpayers to opt to pay either the current personal income tax rate, with all deductions and credits, or to

Table 1 – Potential Revenue from Taxing Certain Services

Item	2002 Receipts (\$million) ¹⁰	7% Sales Tax Revenues
Golf Courses	77.5	5.4
Marinas	68.1	4.8
Fitness Centers	46.8	3.3
Personal Services (excluding funeral services)	216.4	15.1
Personal Repairs & Maintenance	67.3	4.7
TOTAL	476.1	33.3



Table 2 – Rhode Island Residents and Non-Residents Who Benefit from Alternative Flat Tax ¹²

Fiscal Year	Flat Tax Rate	Number of Residents Exercising Option	Number of Non-Residents Exercising Option	Total Cost to State (\$million)	Average Tax Cut
FY2007	8.0	516	1,171	\$7.2	\$4,267
FY2008	7.5	1,073	1,793	\$14.4	\$5,041
FY2009	7.0	1,884	2,500	\$24.5	\$5,585
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	\$73.1	\$5,571

apply a flat tax rate to their federal adjusted gross income, without deductions or credits. The flat tax rate begins at 8 percent for tax year 2007 and falls to 5.5 percent by 2012.

This alternative flat tax is scheduled to cost the state \$14.4 million in FY 2008 and will benefit 2,866 taxpayers (including 1,793 non-resident taxpayers), for an average tax cut of \$5,041. When fully phased in, the alternative flat tax will cost the state \$73 million (in today's dollars) and will benefit 13,119 taxpayers, for an average tax cut of \$5,571. Because the alternative flat tax impacts only those taxpayers subject to the top marginal rates, it is highly regressive in its impact.

V. Freeze the Motor Vehicle Excise Tax Phase-Out

In 2000, lawmakers phased-out the motor vehicle excise tax with the provision that communities would be fully reimbursed for lost revenue beginning in FY 2001. In 2006, the exempt value of motor vehicles was raised from \$5,000 to \$6,000, bringing the total cost of the program to \$139 million for FY 2007. The legislation also promised to continue phasing out the tax by exempting an additional \$250 in value each year, to be paid for by dedicating up to \$10 million in VLT (Video Lottery Terminal) revenues to the phase-out.

But further reductions in this tax will result in large revenue losses for the state with little benefit to low and moderate income taxpayers. With the first \$6,000 in vehicle value currently exempted, low-income car owners already are largely exempt from the tax, so further hikes in the exempt value will not have a progressive impact on the state's overall tax system. The maximum value of the motor vehicle excise tax phase-out is only \$38 per year per \$500 in motor vehicle value in Providence.

Lawmakers should freeze the automatic phase-out of this tax and consider further reductions in the motor vehicle tax in the context of broader property tax reform.

- 1 Poverty Institute, *Where Did the Money Go? Rhode Island's Revenues and Spending 1993 to 2003, May 2003*, p. 12.
- 2 For a more detailed analysis of Rhode Island's tax expenditures, see Poverty Institute, *2006 Tax Expenditures Report, Tax Facts #4, April 2006*.
- 3 National Trust for Historic Preservation, *State Tax Incentives for Historic Preservation: A State-by-State Summary, 2005*.
- 4 New England Public Policy Center at the Federal Reserve Bank of Boston, *Hollywood East? Film Tax Credits in New England, October 2006*.
- 5 State of Louisiana, Legislative Fiscal Office, *Film and Video Tax Credits: Estimated Economic and Fiscal Impacts, March 2005*.
- 6 For more information on corporate taxes and loopholes, see Poverty Institute, *Rhode Island's Disappearing Corporate Income Tax, Tax Facts #2, March 2006*.
- 7 Daniel Wilson, *The Mystery of Falling State Corporate Income Taxes*, Federal Reserve Bank of San Francisco Economic Letter, December 2006.
- 8 Center for Budget and Policy Priorities, *Faulty Foundations: State Structural Budget Problems and How to Fix Them, May 2005*.
- 10 Institute for Taxation and Economic Policy, *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States, 2003*.
- 11 United States Census Bureau, *2002 Economic Census*
- 12 Internal Revenue Service, *2004 Statistics of Income*
- 13 Senate Fiscal Advisory Staff Analysis, 2006